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SOCIAL SECURITY TRUST FUND INVESTMENT POLICY

TUESDAY, JUNE 8, 1982

U.S. SENATE,
COMMITTEE ON FINANCE,
SUBCOMMITTEE ON SOCIAL SECURITY AND
INCOME MAINTENANCE PROGRAMS,
Washington, D.C.

The subcommittee met, pursuant to notice, at 2:05 p.m., in room 2221, Dirksen Senate Office Building, Hon. William L. Armstrong (chairman of the subcommittee) presiding.

Present: Senators Armstrong, Dole, Moynihan, Proxmire, and Stennis.

[The committee press release and Senator Armstrong's opening statement follow:]

Press Release No. 82- 138

PRESS RELEASE

FOR IMMEDIATE RELEASE
May 27, 1982

UNITED STATES SENATE
COMMITTEE ON FINANCE
Subcommittee on Social Security
and Income Maintenance Programs
2227 Dirksen Senate Office Building

FINANCE SUBCOMMITTEE ON SOCIAL SECURITY AND INCOME MAINTENANCE PROGRAMS ANNOUNCES HEARING ON SOCIAL SECURITY TRUST FUND INVESTMENT POLICY

Senator Bill Armstrong, chairman of the Subcommittee on Social Security and Income Maintenance Programs of the Senate Committee on Finance, announced today that the subcommittee will hold a hearing on Tuesday, June 8, 1982 on investment policies for the social security trust funds.

The hearing will begin at 2:00 p.m. in Room 2221 of the Dirksen Senate Office Building.

The subcommittee will hear testimony from Senator John Stennis (D.-Miss.), Senator William Proxmire (D-Wisc.), Mr. Robert Myers, Executive Director of the National Commission on Social Security Reform, Mr. Mark Stalnecker, Deputy Assistant Secretary of the Treasury, Dr. Alice Rivlin, Director of the Congressional Budget Office, and a representative of the Social Security Administration.

Critics of current practice argue that conservative and outdated investment policies are resulting in an artificially low yield on trust fund assets that deprives the trust funds of substantial income. In announcing the hearing, Senator Armstrong noted "a careful examination of these claims is warranted given the critical condition of the trust funds." He urged caution in altering current policy, however, because of social security's special requirements for safety and liquidity. He also noted that the National Commission on Social Security Reform, of which he is a member, will be carefully considering all aspects of social security financing so as to make recommendations for restoring the financial integrity of the system.

STATEMENT BY SENATOR ARMSTRONG

The subject of today's hearing is the investment of the social security trust funds. Two developments underlie the recent interest in trust fund investment practices: first, the high level of interest rates, and second, the deteriorating financial condition of the social security trust funds. High short-term interest rates have created a tremendous flow of money into money market mutual funds which invest primarily or even exclusively in U.S. Treasury bills and notes. These private funds have obtained very high rates of return over the past year or two, while holders of long-term bonds have watched the value of their portfolios decline.

These circumstances along with the precarious financial condition of social security have prompted Senator Proxmire and other members of Congress to express concern that the social security trust funds could be invested so as to reap a higher return. Critics charge that sticking to the old "tried and true" social security investment practices—those that made sense when interest rates were lower and less volatile—is resulting in a loss of interest income to the trust funds. Others believe that current investment practices insure a fair, safe and secure rate of return for funds held in the social security trust funds.

I look forward to the testimony of the witnesses on this issue. I also understand that Senator Proxmire has a few new ideas about the proper manner in which social security funds should be invested, and I look forward to hearing about them.

Let me note, with great regret, that there is not all that much money in the social security trust funds. In fact, the trust funds will largely be depleted by the year 1984 unless Congress takes decisive action to keep social security solvent. I commend Senator Proxmire and others for their initiative in helping to bring attention to the return on social security funds and the possibility of improving that return. Even if we are able to double the return on assets, however, we will only increase assets for the system by less than 1 percent of current outlays. This compares to the more than $100 billion that the system is likely to require to remain solvent in the next decade.

Let me conclude on a note of caution: modifying the interest rate formula so as to take advantage of the presently high short-term rates could well lead to a loss of interest income as interest rates begin to fall—an undesirable prospect given the system's impending bankruptcy.

To make the record complete, I would like to insert at this point a discussion of the current law and practices now used in the investment of the social security funds, along with a brief discussion of the three bills before us today.

PRESENT LAW

Under present law, Treasury operates under a basic set of statutory guidelines that have been in effect since 1960. The Secretary of the Treasury serves as Managing Trustee and takes responsibility for deciding how the trust fund assets are invested. Investments must be made exclusively in U.S. Government obligations and, in particular, in special U.S. Treasury issues not available on the open market (unless it is deemed "in the public interest" to buy securities on the open market). While the maturities of special issues are set by the Secretary, the interest rate paid is determined by law. An important feature of the special issues is that they are redeemable at par at any time. In other words, they can be cashed in at full face value, even if there are years left until maturity. This protects the trust funds from capital losses in the event securities have to be sold before maturity in order to meet benefits.

To date, trust fund reserves have been invested almost exclusively in special issue bonds, with maturities ranging from 1 to 15 years. Roughly 90 percent of the assets of the Old Age and Survivors Insurance trust fund are invested in special issues, with interest rates ranging from 8¼ percent to 13⅝ percent, depending on when the securities were issued. According to the Board of Trustees, the OASDI funds earned $2.3 billion in interest income during fiscal year 1981—a 9.2 percent effective annual yield on investments. The Hospital Insurance and Supplementary Medical Insurance funds earned $1.7 billion, representing an 8.9 percent return on HI investments and an 8.7 percent yield on SMI investments.

PROPOSALS FOR CHANGE

Five bills have now been introduced into Congress to modify the method of investing social security's reserves, three of which we will hear about today. Senator Proxmire's bill (S. 1528) would make several sweeping changes in current policy—altering the statutory mandate given to the Trustees so as to make it their duty to maximize the return on investments, expanding the size of the Board of Trustees to include members of the public, and altering the formula used to determine interest on the special obligations issued to the trust funds. Much of what is now done by Treasury in a relatively mechanical way, by procedure, would be replaced by discretionary actions within the law. This is basically the approach of S. 1768, introduced by Senator Stennis. Congressman Shamansky's bill (H.R. 5987, by contrast, would effectively eliminate the role of Treasury or the Board of Trustees as portfolio investment managers. Instead, an interest-bearing savings account would be created to hold reserves.

Senator ARMSTRONG. The subcommittee will come to order.

The subject of today's hearing is the investment of the social security trust funds, a matter which is of importance and interest to all because of, first, the high level of interest rates, and second, the deteriorating financial condition of the social security trust funds themselves.

In the interest of time, I am going to insert in the record a brief discussion of these issues and some factual material that hopefully will put this hearing into perspective.

[The material referred to follows:]

June 7, 1982
Prepared by
Finance Committe
Staff

INVESTMENT OF SOCIAL SECURITY TRUST FUNDS: PRESENT LAW AND PRACTICE

The Social Security Act provides the following guidelines for trust fund investment:

> Funds not immediately needed for benefits or administrative expenses are to be invested in interest-bearing obligations guaranteed as to both principal and interest by the United States Government.
>
> The Managing Trustee is required to invest in special public-debt obligations -- special issues to the trust funds not available to the general public -- except where he determines that the purchase of obligations available in the open market is "in the public interest."
>
> Special issues shall have maturities fixed with "due regard" for the needs of the trust funds and will pay a rate of interest equal to the average market yield on all marketable interest-bearing obligations of the United States which are not due or callable (redeemable) for at least 4 years.
>
> Marketable securities purchased by the trust funds may be sold at the market price and special issue obligations may be redeemed at par plus accrued interest (without penalty for redemption before maturity).

Under these guidelines, the Managing Trustee -- Secretary of the Treasury -- has invested the great bulk of the trust fund in special issues (93% of January 1982 OASDHI assets). (Short-term special issues are called "certificates of indebtedness;" longer term special issues are referred to as "special issue bonds.") The remainder of the fund monies have been invested in two types of marketable securities: long-term Treasury bonds with maturities at issue of at least 7 years and securities of the Government National Mortgage Association with maturities at issue of 15-20 years.

Setting Maturities

> The maturity dates of newly issued special issues are set not by law, but by procedure, established by the Managing Trustee with the agreement of the other Trustees. Specifically, as soon as payroll-tax revenues are received by the Treasury Department, any funds available for investment are put into certificates of indebtedness, scheduled to mature the following June 30.

Each June 30, the certificates of indebtedness are redeemed and the proceeds are reinvested, or "rolled over," into longer term special issue bonds. The Treasury attempts to set the maturity dates for special issues from 1 to 15 years--so that about 1/15 of the total portfolio of longer term securities comes due in each of the next 15 years. This procedure results, generally, in a sizable proportion of the bonds being purchased on any given June 30 having a maturity of 15 years.

Redeeming Securities

During the year, securities must be sold to meet benefit obligations. Under Treasury procedure, special issues with the shortest durations until maturity are sold first. In the event that there are several securities with the same duration until maturity, those with the lowest interest rate are sold first.

When special issues are sold, they are redeemed by the Treasury Department at their par value which is their purchase price. This option is not available to other purchasers of Federal securities who might wish to sell them and is of considerable financial advantage to the trust funds in times of rising interest rates (which, in general, has been the situation in the last two decades). If the investments were required to be made only in marketable obligations, the securities would be redeemable only on a market-value basis. Under such conditions, significant losses of principal would often be involved. (This would occur if issues had to be redeemed before their maturity. In view of the trust fund performance in recent years, it seems likely that this situation would have arisen.)

After all special issues have been redeemed, Treasury would sell off marketable obligations, incurring a capital loss (or gain), as necessary. In practice, Treasury has never had to sell marketable securities in order to meet trust fund expenses; they have been held until maturity.

Current Holdings of the Trust Funds

As of March 31, 1982, assets of the social security trust funds totalled $47.6 billion. Of this amount, $44.4 billion (93%) was invested in special issues. The break-down of investments between special issues, marketable securities, and participation certificates is shown in Table 1 for each of the trust funds.

Table 2 details the asset holdings of the OASI trust fund. It helps illustrate the impact of Treasury's redemption policy, since OASI outgo has exceeded trust fund income since

1975. No special issue bonds are left in that fund with maturity dates before June 1992. Bonds with earlier maturity dates have been "stripped off" to meet immediate demands on the trust fund. As the trust fund's reserves have declined, the Treasury has been unable to adhere to its own policy of setting maturity dates so that 1/15 of the long term special issue bonds comes due during each of the next 15 years. Also, Treasury's policy of holding marketable securities until maturity has left the OASI trust fund with $2.4 billion in long term Treasury bonds and Government National Mortgage Association (GNMA) participation certificates paying relatively low rates of return. Redemption of these marketable securities, however, would incur a loss of principal which would tend to offset any increase in interest which could be gained by reinvesting them.

Yield

The average yield on OASDI trust fund investments during the 12-month period ending June 30, 1981 was 8.8%. HI fund investments yielded 8.9% during that period, while SMI investments yielded 8.7%. Interest rates on recently purchased special issues are considerably higner -- 13 1/4% in May 1982. According to unpublished information from the Treasury Department, the average yield to the trust funds from all investments in their portfolio was about 10% on Sept. 30, 1981.

Historical data on special issue interest rates, the relation to the average market yield on all marketable interest-bearing obligations of the U.S. Government, and the average yield on trust fund investments are shown in Tables 3-5. Table 6 shows bond yields and interest rates on a variety of public and private financial securities.

Table 1.

DISTRIBUTION OF ASSETS OF SOCIAL SECURITY TRUST FUNDS, BY TYPE, MARCH 31, 1982

(In Millions)

Category	Total	OASI	DI	HI	SMI
Total assets....	$47,600	$18,867	$3,918	$19,703	$5,113
Special issues................	$44,387	$16,003	$3,622	$19,719	$5,043
Marketable securities[a]........	2,243	1,947	296	--	--
Participation certificates....	455	455	--	--	--
Undisbursed balances..........	515	461	--[b]	16[c]	70

a. U.S. Treasury securities only (participation certificates of the Government National Mortgage Association are also marketable, but are not included here).

b. Less than $500,000.

c. Represents an extension of credit that was covered by the redemption of securities on the first day of the following month.

Source: Office of Actuary, SSA.

TABLE 2. Investments of the OASI Trust Fund as of Jan. 31, 1982
(dollars in millions)

Type of Asset		Par Value*	Date Purchased	Maturity
Certificates of indebtedness :				
13 1/2%		$ 8,779	Jan. 1982	June 1982
Special issue bonds :				
7 1/8%		1,813	June 1977	June 1992
8 1/4%		1,556	June 1978	June 1993
8 3/4%		1,273	June 1979	June 1994
9 3/4%		216	June 1980	June 1994
9 3/4%		1,489	June 1980	June 1995
13 %		1,482	June 1981	June 1996
	Subtotal	$ 7,829		
Total special issues : $16,608 (87% of total)				
Marketable Treasury bonds :				
3 %		$ 70	FY55-65	1995
3 1/4%		60	FY53-61	1978-1983
3 1/4%		26	FY61	1985
3 1/2%		556	FY58-62	1990
3 1/2%		552	FY61-62	1998
4 1/8%		91	FY62	1989-1994
4 1/4%		78	FY60-64	1975-1965
4 1/4%		33	FY62-65	1987-1992
6 3/8%		32	FY73	1984
7 1/2%		100	FY74	1986-1993
7 5/8%		15	FY77	2002-2007
7 7/8%		22	FY76	1995-2000
8 %		90	FY77	1996-2001
8 1/4%		22	FY75-76	2000-2005
8 3/8%		50	FY76	1995-2000
8 1/2%		6	FY74	1994-1999
11 3/4%		153	FY80	2010
	Subtotal	$ 1,957		
Participation certificates (GNMA) :				
5.10 %		$ 50	April 1967	1987
6.05 %		65	Jan. 1968	1988
6.20 %		230	Aug. 1968	1988
6.40 %		75	Dec. 1967	1987
6.45 %		35	April 1968	1988
	Subtotal	$ 455		

Total marketable securities : $ 2,412 (13% of total)

Grand total investments : $19,020 (100% of total)

Source: Treasury.

Table 3 -Interest rates on special issues purchased monthly by the Social Security trust funds from January 1951 to December 1981

Month	Rate (percent)							
	1951	1952	1953	1954	1955	1956	1957	1958
January	2.125	2.250	2.250	2.375	2.250	2.375	2.500	2.500
February	2.125	2.250	2.250	2.375	2.250	2.375	2.500	2.500
March	2.125	2.250	2.375	2.375	2.250	2.375	2.500	2.500
April	2.125	2.250	2.375	2.375	2.250	2.500	2.500	2.500
May	2.125	2.250	2.375	2.375	2.250	2.500	2.500	2.500
June	2.125	2.250	2.375	2.250	2.250	2.500	2.500	2.500
July	2.250	2.250	2.375	2.250	2.250	2.500	2.500	2.625
August	2.250	2.250	2.375	2.250	2.250	2.500	2.500	2.625
September	2.250	2.250	2.375	2.250	2.375	2.500	2.500	2.625
October	2.250	2.250	2.375	2.250	2.375	2.500	2.500	2.625
November	2.250	2.250	2.375	2.250	2.375	2.500	2.500	2.625
December	2.250	2.250	2.375	2.250	2.375	2.500	2.500	2.625
Average annual rate	2.188	2.250	2.354	2.302	2.292	2.469	2.500	2.562
	1959	1960	1961	1962	1963	1964	1965	1966
January	2.625	2.625	3.750	4.000	3.750	4.125	4.125	4.625
February	2.625	2.625	3.750	4.000	3.750	4.125	4.125	4.750
March	2.625	2.625	3.625	3.875	3.875	4.125	4.125	5.000
April	2.625	2.625	3.750	3.750	3.875	4.250	4.125	4.750
May	2.625	2.625	3.625	3.750	3.875	4.125	4.125	4.750
June	2.625	2.625	3.750	3.750	3.875	4.125	4.125	4.875
July	2.625	2.625	3.875	3.875	3.875	4.125	4.125	5.000
August	2.625	2.625	3.875	4.000	3.875	4.125	4.125	5.125
September	2.625	2.625	4.000	3.875	4.000	4.125	4.250	5.375
October	2.625	3.625	3.875	3.875	4.000	4.125	4.375	5.125
November	2.625	3.750	3.875	3.750	4.125	4.125	4.375	5.000
December	2.625	4.000	4.000	3.750	4.000	4.125	4.375	5.000
Average annual rate	2.625	2.917	3.812	3.854	3.906	4.135	4.198	4.948
	1967	1968	1969	1970	1971	1972	1973	1974
January	4.625	5.625	6.000	7.750	6.125	5.625	6.125	6.750
February	4.500	5.375	6.125	7.875	5.875	5.875	6.375	6.750
March	4.750	5.375	6.250	7.000	5.625	5.750	6.500	6.875
April	4.375	5.625	6.250	7.000	5.250	6.000	6.625	7.375
May	4.750	5.625	6.125	7.625	6.000	5.875	6.500	7.750
June	4.750	5.625	6.500	7.625	6.125	5.750	6.625	7.625
July	5.125	5.500	6.625	7.500	6.625	6.000	6.750	7.875
August	5.000	5.250	6.625	7.375	6.750	5.875	7.500	8.000
September	5.125	5.375	6.750	7.250	6.000	6.125	7.000	8.125
October	5.250	5.375	7.625	7.000	5.875	6.125	6.500	7.750
November	5.625	5.500	7.000	7.000	5.625	6.125	6.625	7.625
December	5.625	5.625	7.250	6.125	5.875	6.000	6.625	7.375
Average annual rate	4.958	5.490	6.594	7.260	5.979	5.927	6.646	7.490
	1975	1976	1977	1978	1979	1980	1981	
January	7.125	7.250	6.375	7.625	9.000	10.000	11.875	13.500
February	7.125	7.250	7.125	7.750	8.750	10.750	12.125	13.750
March	6.875	7.250	7.125	7.875	9.000	12.375	12.875	13.625
April	7.250	7.125	7.125	8.000	8.875	12.250	12.500	13.625
May	7.625	7.125	7.125	8.000	9.000	10.375	13.500	13.250
June	7.375	7.500	7.125	8.250	8.750	9.750	13.000	
July	7.375	7.375	7.000	8.375	8.500	9.625	13.250	
August	7.500	7.250	7.125	8.375	8.750	10.125	14.000	
September	7.625	7.125	7.000	8.250	9.000	11.125	14.875	
October	7.875	7.125	7.125	8.375	9.250	11.500	15.250	
November	7.375	6.875	7.375	8.875	10.500	12.000	14.250	
December	7.625	6.500	7.375	8.625	10.000	12.125	12.500	
Average annual rate	7.396	7.146	7.083	8.198	9.115	11.000	13.333	

and Office of Actuary, SSA, June 1982.

TABLE 4.- Average market yield rate on marketable interest-bearing obligations of the United States

June of:	Trust Funds Special-Issue Rate a/	All Obligations	Difference (in percentage points)
1981	13%	14 7/8%	-1 7/8
1980	9 3/4	8 7/8	7/8
1979	8 3/4	9 1/2	-3/4
1978	8 1/4	7 3/4	1/2
1977	7 1/8	6	1 1/8
1976	7 1/2	6 5/8	7/8
1975	7 3/8	6 1/4	1 1/8
1974	7 5/8	8 3/8	-3/4
1973	6 5/8	6 7/8	-1/4
1972	5 3/4	4 5/8	-1 1/8
1971	6 1/8	5 1/4	7/8
1970	7 5/8	5 1/2	2 1/8
1969	6 1/2	6 1/2	---
1968	5 5/8	5 3/4	-1/8
1967	4 3/4	4 1/8	5/8

a/ Average market yield rate of U.S. marketable obligations with 4 or more years until maturity.

Source: Social Security Administration

TABLE 5.- Assets, average yields, and interest income to the Social Security trust funds, FY71 through FY81

Cash Benefits Programs
(dollars in billions)

	OASI Assets a/	DI Assets a/	Average Yield(%)	Interest Income
FY81	$23.2	$3.4	8.8 b/	$2.3
FY80	24.6	7.7	8.4 b/	2.3
FY79	27.7	5.6	7.4 b/	2.2
FY78	31.0	4.4	7.2 b/	2.4
FY77	35.4	4.2	6.9 b/	2.6
FY76	38.0	6.9	6.8	2.8
FY75	40.0	8.2	6.5	2.8
FY74	37.9	8.2	6.0	2.5
FY73	36.4	7.9	5.6	2.3
FY72	36.3	7.4	5.2	2.1
FY71	34.3	6.4	5.0	1.9

Medicare
(dollars in billions)

	HI Assets	SMI Assets	Average Yield(%)	Interest Income
End of:				
FY81	$18.2	$3.8	c/	$1.6
FY80	14.5	4.5	8.2 b/	1.4
FY79	13.4	5.0	7.7 b/	1.2
FY78	11.8	4.0	7.4 b/	1.0
FY77	11.1	2.3	7.3 b/	0.9
FY76	10.8	1.2	7.2	0.8
FY75	9.9	1.4	7.2	0.7
FY74	7.9	1.3	6.7	0.5
FY73	4.4	0.7	6.4	0.2
FY72	2.9	0.5	6.2	0.2
FY71	3.1	0.3	6.5	0.2

---

a/ As of end of year shown.
b/ For year ending June 30.
c/ Combined rate not available, but average yield on HI trust fund assets during year ending June 30, 1981 was 8.9%; SMI yield was 8.7%.

TABLE 6. —Bond yields and interest rates, 1929–81

[Percent per annum]

Year or month	U.S. Treasury securities				Corporate bonds (Moody's)		High-grade municipal bonds (Standard & Poor's)	New-home mortgage yields (FHLBB)[3]	Prime commercial paper, 4–6 months	Prime rate charged by banks[4]	Discount rate, Federal Reserve Bank of New York[4]	Federal funds rate[5]
	Bills (new issues)[1]		Constant maturities[2]									
	3-month	6-month	3 years	10 years	Aaa	Baa						
1929	—	—	—	—	4.73	5.90	4.27	—	5.85	5½–6	5.16	—
1933	0.515	—	—	—	4.49	7.76	4.71	—	1.73	1½–4	2.56	—
1939	.023	—	—	—	3.01	4.96	2.76	—	.59	1.50	1.00	—
1940	.014	—	—	—	2.84	4.75	2.50	—	.56	1.50	1.00	—
1941	.103	—	—	—	2.77	4.33	2.10	—	.53	1.50	1.00	—
1942	.326	—	—	—	2.83	4.28	2.36	—	.66	1.50	[6]1.00	—
1943	.373	—	—	—	2.73	3.91	2.06	—	.69	1.50	[6]1.00	—
1944	.375	—	—	—	2.72	3.61	1.86	—	.73	1.50	[6]1.00	—
1945	.375	—	—	—	2.62	3.29	1.67	—	.75	1.50	[6]1.00	—
1946	.375	—	—	—	2.53	3.05	1.64	—	.81	1.50	[6]1.00	—
1947	.594	—	—	—	2.61	3.24	2.01	—	1.03	1½–1¾	1.00	—
1948	1.040	—	—	—	2.82	3.47	2.40	—	1.44	1¾–2	1.34	—
1949	1.102	—	—	—	2.66	3.42	2.21	—	1.49	2.00	1.50	—
1950	1.218	—	—	—	2.62	3.24	1.98	—	1.45	2.07	1.59	—
1951	1.552	—	—	—	2.86	3.41	2.00	—	2.16	2.56	1.75	—
1952	1.766	—	—	—	2.96	3.52	2.19	—	2.33	3.00	1.75	—
1953	1.931	—	2.47	2.85	3.20	3.74	2.72	—	2.52	3.17	1.99	—
1954	.953	—	1.63	2.40	2.90	3.51	2.37	—	1.58	3.05	1.60	—
1955	1.753	—	2.47	2.82	3.06	3.53	2.53	—	2.18	3.16	1.89	1.78
1956	2.658	—	3.19	3.18	3.36	3.88	2.93	—	3.31	3.77	2.77	2.73
1957	3.267	—	3.98	3.65	3.89	4.71	3.60	—	3.81	4.20	3.12	3.11
1958	1.839	—	2.84	3.32	3.79	4.73	3.56	—	2.46	3.83	2.15	1.57
1959	3.405	3.832	4.46	4.33	4.38	5.05	3.95	—	3.97	4.48	3.36	3.30
1960	2.928	3.247	3.98	4.12	4.41	5.19	3.73	—	3.85	4.82	3.53	3.22
1961	2.378	2.605	3.54	3.88	4.35	5.08	3.46	—	2.97	4.50	3.00	1.96
1962	2.778	2.908	3.47	3.95	4.33	5.02	3.18	—	3.26	4.50	3.00	2.68
1963	3.157	3.253	3.67	4.00	4.26	4.86	3.23	5.89	3.55	4.50	3.23	3.18
1964	3.549	3.686	4.03	4.19	4.40	4.83	3.22	5.83	3.97	4.50	3.55	3.50
1965	3.954	4.055	4.22	4.28	4.49	4.87	3.27	5.81	4.38	4.54	4.04	4.07
1966	4.881	5.082	5.23	4.92	5.13	5.67	3.82	6.25	5.55	5.63	4.50	5.11
1967	4.321	4.630	5.03	5.07	5.51	6.23	3.98	6.46	5.10	5.61	4.19	4.22
1968	5.339	5.470	5.68	5.65	6.18	6.94	4.51	6.97	5.90	6.30	5.16	5.66
1969	6.677	6.853	7.02	6.67	7.03	7.81	5.81	7.81	7.83	7.96	5.87	8.20
1970	6.458	6.562	7.29	7.35	8.04	9.11	6.51	8.45	7.71	7.91	5.95	7.18
1971	4.348	4.511	5.65	6.16	7.39	8.56	5.70	7.74	5.11	5.72	4.88	4.66
1972	4.071	4.466	5.72	6.21	7.21	8.16	5.27	7.60	4.73	5.25	4.50	4.43
1973	7.041	7.178	6.95	6.84	7.44	8.24	5.18	7.96	8.15	8.03	6.44	8.73
1974	7.886	7.926	7.82	7.56	8.57	9.50	6.09	8.92	9.84	10.81	7.83	10.50
1975	5.838	6.122	7.49	7.99	8.83	10.61	6.89	9.00	6.32	7.86	6.25	5.82
1976	4.989	5.266	6.77	7.61	8.43	9.75	6.49	9.00	5.34	6.84	5.50	5.04
1977	5.265	5.510	6.69	7.42	8.02	8.97	5.56	9.02	5.61	6.83	5.46	5.54
1978	7.221	7.572	8.29	8.41	8.73	9.49	5.90	9.56	7.99	9.06	7.46	7.93
1979	10.041	10.017	9.72	9.44	9.63	10.69	6.39	10.78	[7]10.91	12.67	10.28	11.19
1980	11.506	11.374	11.55	11.46	11.94	13.67	8.51	12.66	12.29	15.27	11.77	13.36
1981	14.077	13.811	14.44	13.91	14.17	16.04	11.23	14.70	14.76	18.87	13.41	16.38

See next page for continuation of table.

Source: Economic Report of the President, 1982.

TABLE 6 —Bond yields and interest rates, 1929–81—Continued

[Percent per annum]

Year or month	U.S. Treasury securities				Corporate bonds (Moody's)		High-grade municipal bonds (Standard & Poor's)	New-home mortgage yields (FHLBB)[3]	Prime commercial paper, 4–6 months	Prime rate charged by banks[4]	Discount rate, Federal Reserve Bank of New York[4]	Federal funds rate[5]
	Bills (new issues)[1]		Constant maturities[2]									
	3-month	6-month	3 years	10 years	Aaa	Baa						
1979:												
Jan	9.351	9.501	9.50	9.10	9.25	10.13	6.25	10.18	10.32	11¾–11¾	9½–9½	10.07
Feb	9.265	9.349	9.29	9.10	9.26	10.08	6.19	10.20	10.01	11¾–11¾	9½–9½	10.06
Mar	9.457	9.458	9.38	9.12	9.37	10.26	6.16	10.30	9.96	11¾–11¾	9½–9½	10.09
Apr	9.493	9.498	9.43	9.18	9.38	10.33	6.14	10.36	9.87	11¾–11¾	9½–9½	10.01
May	9.579	9.531	9.42	9.25	9.50	10.47	6.10	10.47	9.98	11¾–11¾	9½–9½	10.24
June	9.045	9.062	8.95	8.91	9.29	10.38	5.99	10.66	9.71	11¾–11½	9½–9½	10.29
July	9.262	9.190	8.94	8.95	9.20	10.29	6.05	10.78	9.82	11½–11¾	9½–10	10.47
Aug	9.450	9.450	9.14	9.03	9.23	10.35	6.10	11.01	10.39	11¾–12¼	10–10½	10.94
Sept	10.182	10.125	9.69	9.33	9.44	10.54	6.40	11.02	11.60	12¼–13¼	10½–11	11.43
Oct	11.472	11.339	10.95	10.30	10.13	11.40	6.98	11.21	13.23	13½–15	11–12	13.77
Nov	11.868	11.856	11.18	10.65	10.76	11.99	7.19	11.37	[7]13.26	15½–15¾	12–12	13.18
Dec	12.071	11.847	10.71	10.39	10.74	12.06	7.09	11.64	12.80	15¾–15¼	12–12	13.78
1980:												
Jan	12.036	11.851	10.88	10.80	11.09	12.42	7.21	11.87	12.66	15¼–15¼	12–12	13.82
Feb	12.814	12.721	12.84	12.41	12.38	13.57	8.04	11.93	13.60	15¼–16¾	12–13	14.13
Mar	15.526	15.100	14.05	12.75	12.96	14.45	9.09	12.62	16.50	16¾–19½	13–13	17.19
Apr	14.003	13.618	12.02	11.47	12.04	14.19	8.40	13.03	14.93	19½–19½	13–13	17.61
May	9.150	9.149	9.44	10.18	10.99	13.17	7.37	13.68	9.29	[8]18½–14	13–12	10.98
June	6.995	7.218	8.91	9.78	10.58	12.71	7.60	12.66	8.03	14–12	12–11	9.47
July	8.126	8.101	9.27	10.25	11.07	12.65	8.08	12.48	8.29	12–11	11–10	9.03
Aug	9.259	9.443	10.63	11.10	11.64	13.15	8.52	12.25	9.61	11–11½	10–10	9.61
Sept	10.321	10.546	11.57	11.51	12.02	13.70	8.95	12.35	11.04	11½–13	10–11	10.87
Oct	11.580	11.566	12.01	11.75	12.31	14.23	9.11	12.61	12.32	13½–14½	11–11	12.81
Nov	13.888	13.612	13.31	12.68	12.97	14.64	9.55	13.04	14.73	14½–17¾	11–12	15.85
Dec	15.661	14.770	13.65	12.84	13.21	15.14	10.09	13.28	16.49	17¾–21½	12–13	18.90
1981:												
Jan	14.724	13.883	13.01	12.57	12.81	15.03	9.65	13.26	15.10	21½–20	13–13	19.08
Feb	14.905	14.134	13.65	13.19	13.35	15.37	10.03	13.54	14.87	20–19	13–13	15.93
Mar	13.478	12.983	13.51	13.12	13.33	15.34	10.12	14.02	13.59	19–17½	13–13	14.70
Apr	13.635	13.434	14.09	13.68	13.88	15.56	10.55	14.15	14.17	17½–18	13–13	15.72
May	16.295	15.334	15.08	14.10	14.32	15.95	10.73	14.10	16.66	18–20½	13–14	18.52
June	14.557	13.947	14.29	13.47	13.75	15.80	10.56	14.67	15.22	20½–20	14–14	19.10
July	14.699	14.402	15.15	14.28	14.38	16.17	11.03	14.72	16.09	20–20½	14–14	19.04
Aug	15.612	15.548	16.00	14.94	14.89	16.34	12.13	15.27	16.62	20½–20½	14–14	17.82
Sept	14.951	15.057	16.22	15.32	15.49	16.92	12.86	15.29	15.93	20½–19½	14–14	15.87
Oct	13.873	14.013	15.50	15.15	15.40	17.11	12.67	15.65	14.72	19½–18	14–14	15.08
Nov	11.269	11.530	13.11	13.39	14.22	16.39	11.71	16.38	11.96	18–16	14–13	13.31
Dec	10.926	11.471	13.66	13.72	14.23	16.55	12.77	15.87	12.14	15¾–15¾	13–12	12.37

[1] Rate on new issues within period; bank-discount basis.

[2] Yields on the more actively traded issues adjusted to constant maturities by the Treasury Department.

[3] Effective rate (in the primary market) on conventional mortgages, reflecting fees and charges as well as contract rate and assuming on the average, repayment at end of 10 years. Rates beginning January 1973 not strictly comparable with prior rates.

[4] For monthly data, opening and closing rate. Prime rate for 1929–33 and 1947–48 are ranges of the rate in effect during the period.

[5] Since July 19, 1975, the daily effective rate is an average of the rates on a given day weighted by the volume of transactions at these rates. Prior to that date, the daily effective rate was the rate considered most representative of the day's transactions, usually the one at which most transactions occurred.

[6] From October 30, 1942, to April 24, 1946, a preferential rate of 0.50 percent was in effect for advances secured by Government securities maturing in 1 year or less.

[7] Beginning November 1979, data are for 6-months paper.

[8] On May 1, range of 18½–19 was in effect.

Sources: Department of the Treasury, Board of Governors of the Federal Reserve System, Federal Home Loan Bank Board (FHLBB), Moody's Investors Service, and Standard & Poor's Corporation.

Senator ARMSTRONG. We are very glad to welcome this afternoon two of the most distinguished Members of the Senate who are sponsors of the legislation, S. 1528, which is the subject of this hearing.

The first to be heard by the committee is our distinguished colleague from Wisconsin, Mr. Proxmire.

STATEMENT OF HON. WILLIAM PROXMIRE, A U.S. SENATOR FROM THE STATE OF WISCONSIN

Senator PROXMIRE. Thank you very much, Mr. Chairman, and Chairman Dole.

I am going to abbreviate my testimony, and I ask unanimous consent, Mr. Chairman, to have the full statement printed in the record.

Senator ARMSTRONG. It will, of course, be printed in the record.

Senator PROXMIRE. Mr. Chairman, I want to commend you and the other members of the subcommittee for holding these timely hearings on the investment policies of the social security trust funds. I introduced the first bill on trust fund investments in S. 1528 on July 29, 1981. The purpose of my bill is to guarantee that the trust funds always earn a rate of interest on their investment that is comparable to current market rates.

Under the present system, the yield on trust fund investments has consistently lagged behind current rates. Today in my statement I am recommending that the system for determining trust fund interest be changed so that the trust funds will always earn a rate of interest equal to the Treasury's current cost of money—no more and no less. That approach is recommended by the General Accounting Office. It is also supported by the Congressional Budget Office with certain modifications.

Had my approach been in effect over the last 22 years, the trust funds would have more than $18 billion in reserves today more than they have now.

Congress last revised the law governing trust fund investments in 1960, and I believe it is time for this subcommittee to review the current system and determine whether it provides a fair and equitable return to the millions of our citizens on social security.

As a starting point for this review, consider the experience for the most recent fiscal year ending on June 30, 1981. During that period, the four Social Security Trust Funds maintained an average balance of $43 billion that was invested in Treasury securities. The funds received $3.9 billion in interest on these investments, and earned an average yield of 9.1 percent. During that same period, the composite rate on all Treasury securities was 13.2 percent, or more than 4 percentage points higher than the yield earned by the Social Security Trust Funds. Had the funds been able to increase the yield in their investments by 4 percentage points, they would have received an additional $1.7 billion in interest payments for that year.

Now, is this an isolated example peculiar to 1981, or is it typical of the investment performance realized by the managers of the funds? To answer that question, consider the following investment results since 1960, when Congress last revised the law.

The average yield earned by the funds was below the current rate on all Treasury securities in 17 of the last 21 fiscal years. Over the last 21 years, the funds received an average annual yield of 5.2 percent. During the same period, the average market rate on all Treasury securities was 6.3 percent. Had the funds earned interest at the current market rate on all Treasury securities, they would have received an additional $14.9 billion in interest payments over the last 21 years. In no year would the interest have been less than what was actually earned under the present system.

Now, by not receiving interest at current market rates, the fund lost an average of $700 million a year over the last 21 years.

What accounts for these poor results? Are the managers of the funds guilty of incompetence or malfeasance, or is the system at fault?

The managers of the funds must bear some responsibility for the poor investment results. However, much of the blame lies with the system established by Congress and the executive branch over 20 years ago. Under that system, Congress has given the Secretary of the Treasury the job of investing the reserves of the funds. These reserves are to be invested in special issues of the U.S. Treasury unless the Secretary determines it is in the public interest to invest in marketable securities issued or guaranteed by the United States.

The interest rate on special issues is set by law at the average yield on all outstanding marketable Treasury obligations with maturities greater than 4 years. The law further provides that that maturities of special issues are to be fixed with due regard to the needs of the trust fund. Finally, the law provides that special issues may be redeemed any time at par.

Now, since the trust funds are essentially limited to investments in special issues with interest rates that are fixed by law, the only way the Secretary of the Treasury can affect the yield received by the funds is by managing the maturities of their investments.

In general, a policy of investing in longer term securities will cause the yield received by the funds to lag consistently behind current market rates if interest rates are rising over a sustained period of time. That is because the funds are locked into lower yielding investments made in earlier years, and are unable to take full advantage of the higher rates currently available.

On the other hand, if interest rates persistently decline, a policy of investing in long-term securities will produce yields that consistently exceed current market rates.

Now, a policy of investing only in short-term securities will allow the funds to earn a yield that is always close to the current market rate. That works to the advantage of the fund during periods when interest rates are persistently rising, compared to what would have been earned if the fund invested in long-term securities, but it works to the disadvantage of the fund if interest rates persistently decline.

It is also legally possible for the Secretary of the Treasury to shift between long-term and short-term investments depending upon the investment outlook. The discretionary approach could result in yields that are higher or lower than the yields obtained through a fixed policy, depending upon the ability of the Secretary to make correct predictions about the future course of interest rates.

Despite the legal authority to employ discretion, the Secretary of the Treasury has consistently followed a fixed approach of spreading maturities as equally as possible over a 15-year period. Part of the reasoning behind this approach seems to involve a desire to avoid criticism for making potentially wrong predictions about future interest rate developments.

The 15-year maturity policy may have appeared reasonable in the late fifties when it was first established. The trust funds were accruing annual surpluses. It seemed logical to invest them in long-term issues, since benefit payments would not be needed for many years into the future. Moreover, long-term rates at the time substantially exceeded short-term rate, and no one was predicting a sustained 20-year rise in the level of interest rates.

With the benefit of hindsight, the 15-year maturity policy has proven to be a fiscal disaster, for the funds. Interest rates have persistently risen over the last two decades, and are almost four times higher than they were 20 years ago. As a result, the yield earned by the funds has almost always lagged behind current market rate. Only maturing investments or new reserves could be invested at the higher current rates. The bulk of the reserves were locked into lower yielding investments made in past years.

Clearly, the funds would have been better off by investing only in 6-month Treasury bills at current market rates. Had such a policy been followed, the fund would have earned an additional $11.7 billion in interest payments over the last 21 years. The experience over the last 21 years suggests that Congress needs to reconsider the present rigid system which offers no protection to the funds during periods of prolonged inflation and rising interest rates.

There are several options Congress might consider in establishing investment policies for the funds for the next 20 years. The first would be to continue the present system without major change. That is essentially the Treasury position. The argument made for keeping the current system is that because interest rates have risen over the last two decades does not mean they will necessarily continue to rise over the next two decades. Interest rates may well have reached an historic high. On the other hand, continuing the present system without change does subject the funds to the risk of a further erosion of interest earnings if interest rates continue to rise. Over the last few years, how many economists and financial analysts have pronounced that interest rates have peaked, only to be proven wrong?

A second option would be to expand the board of trustees and direct it to exercise discretionary investment management in order to maximize the yield of the funds. That is the approach taken in S. 1528 as I have introduced it. That is not the approach I take now. That bill is predicated on the belief that discretionary management should be able to produce yields over time that exceed any investment policy. Congress cannot possibly foresee all future developments in credit markets. Most funds in the private sector are actively managed on a day-to-day basis in order to take advantage of the constantly changing investment outlook.

Nevertheless, the concept of discretionary management has not met with universal acceptance among those who have studied the problem. Some fear that lower yields might be realized if the board of trustees consistently made the wrong investment choice. Others are concerned about maintaining public confidence in the soundness of the social security system. They are worried that confidence might be impaired if it were to be perceived that the trustees were speculating with the reserves of the funds.

Now, should the subcommittee find the discretionary approach infeasible, I would be willing to consider other options designed to give the funds better protection than the present system.

In fact, here is what I recommend now, Mr. Chairman. I recommend that we scrap the present system for investing in specific maturities and simply allow the funds to deposit their reserves in a savings type account maintained at the Treasury. Interest on these deposits would be paid at a rate equal to the current market rate on all Treasury securities. Funds could be deposited in or withdrawn from the account at any time without penalty. That is essentially the system recommended by the General Accounting Office when it studied the issue in 1975.

The advantages of the savings account approach are that it does away with the present complicated procedure for attempting to keep maturities spread equally over a 15-year period. It avoids any argument over which securities to redeem whenever the funds must make a withdrawal to meet current benefit payments. It eliminates any need to try to guess which way interest rates may be heading in the future. And above all, it guarantees that the funds will always earn interest at a rate equal to the Treasury's current cost of money, no more and no less.

I think that is what the American people would far more willingly accept than any other system. They do not think the funds should make out better, they do not think it should make out worse than the private investors who invest in Treasury securities.

It should be noted that if interest rates decline substantially over the next several years, the savings account approach might earn less interest for the funds compared to the present system. However, the prospect of additional interest profits must be weighed against the risk of a further erosion in interest earnings if interest rates continue to increase.

If interest rates do in fact decline substantially in the next few years, the funds will be in a much stronger financial condition because of the parallel reduction in inflation. So my approach will achieve a better relationship between interest earnings and the cash needs of the funds. When the funds suffer a cash drain because of rising inflation, higher interest payments will help to bridge the gap. Similarly, when the funds improve their cash flow because of declining inflation, they will be able to absorb lower interest payments.

If the savings account approach had been in effect over the last 21 years ending on June 30, 1981, the funds would have earned an additional $14.9 billion in interest payments. In no year would the interest earned under the savings account approach have been less than the actual interest received under the current system.

If preliminary fiscal year 1982 data are included, the cumulative amount of lost interest will exceed $18.5 billion, an average shortfall of over $800 million a year.

The savings account approach could also save the fund between $1 billion and $1.6 billion in fiscal 1983 and 1984 based on the financial projections related by the board of trustees last April. That estimate assumes that all special issues would be redeemed at par during the first 6 months of fiscal 1983. If special issues were held for a longer period, the savings would not be as great.

Mr. Chairman, I am certainly not suggesting that a revision to the investment policies will solve all the financial problems of the social security trust funds. Nonetheless, $18.5 billion in lost interest payments over 22 years is not exactly a trivial amount. If the reserves of the funds were to be increased by $18.5 billion, the Congress might not have to consider all of the difficult measures deemed necessary for restoring the solvency of the fund.

Obviously, it would not be appropriate to try to compensate the fund for all the interest lost by the present system, and I am not proposing to do that. However, this subcommittee and the Congress must look to the future. It is clear that the present system is not working. Timely action today can lay the groundwork for a more rational investment policy so that we are not faced with the same problem two decades from now.

I ask unanimous consent that several tables be included in the record at the end of my statement together with a draft of the savings account approach as an alternative to S. 1528.

[The prepared statement, with attachments, of Senator Proxmire follow:]

Statement of Senator William Proxmire

Before the Subcommittee on Social Security and Income Maintenance Programs

Senate Committee on Finance
June 8, 1982
on
S. 1528, Social Security Trust Fund Investments

Mr. Chairman, I want to commend you and the other members of the Subcommittee for holding these timely hearings on my legislation to strengthen our current system for investing the reserves of the Social Security Trust Funds. Congress last revised the law governing Trust Fund investments in 1960. I believe it is time for this Subcommittee to review the current system and determine whether it provides a fair and equitable return to the millions of our citizens on Social Security.

As a starting point for this review, consider the experience for the most recent fiscal year ending on June 30, 1981. During this period, the four Social Security Trust Funds maintained an average balance of $43 billion that was invested in Treasury securities. The Funds received $3.9 billion in interest on these investments and earned an average yield of 9.1 percent.

During the same period, the composite rate on all Treasury securities was 13.2 percent, or more than four percentage points higher than the yield earned by the Social Security Trust Funds. Had the Funds been able to increase the yield on their investments by four percentage points, they would have received an additional $1.7 billion in interest payments.

Is this an isolated example peculiar to 1981, or is it typical of the investment performance realized by the managers of the Funds? To answer that question, consider the following investment results since 1960 when Congress last revised the law.

- The average yield earned by the Funds was below the current rate on all Treasury securities in 17 of the last 21 fiscal years;

- Over the last 21 years, the Funds received an average annual yield of 5.2 percent. During the same period, the average market rate on all Treasury securities was 6.3 percent;

- Had the Funds earned interest at the current market rate on all Treasury securities, they would have received an additional $14.9 billion in interest payments over the last 21 years;

- By not receiving interest at current market rates the Funds lost an average of $700 million a year over the last 21 years.

What accounts for these poor results? Are the managers of the Funds guilty of incompetence or malfeasance? Or is the system at fault?

The managers of the Funds must bear some responsibility for the poor investment results. However, much of the blame lies with the system established by the Congress and the Executive Branch over 20 years ago. Under that system, Congress has given the Secretary of the Treasury the job of investing the reserves of the Funds. These reserves are to be invested in special issues of the U.S. Treasury unless the Secretary determines it is in the public interest to invest in marketable securities issued or guaranteed by the United States. In practice, the Secretary has rarely authorized investments in marketable securities - over 93 percent of Trust Fund assets are currently invested in special issues.

The interest rate on special issues is set by law at the average yield on all outstanding marketable Treasury obligations with maturities greater than four years. All special issues earn this rate regardless of maturity. The rate is fixed at the time of issue and does not vary over time.

The law further provides that the maturities of special issues are to be fixed with due regard for the needs of the Trust Fund. Although the law allows discretion in the selection of maturities, the Secretary of the Treasury has consistently followed a policy of spreading the maturities of special issues as equally as possible over a 15-year period. This system was already in effect in 1960 when Congress last revised the law.

Finally, the law provides that special issues may be redeemed any time at par. While the law is not specific, the Treasury has limited redemptions only when needed to meet current benefit payments. This provision has been advantageous to the Funds in recent years when investments had to be redeemed to meet current benefit payments. Without the redemption-at-par feature, the Funds would have incurred substantial capital losses. On the other hand, the Treasury has not permitted the Funds to use the redemption-at-par authority in order to take advantage of changes in interest rates.

Since the Trust Funds are essentially limited to investments in special issues with interest rates that are fixed by law, the only way the Secretary of the Treasury can affect the yield received by the Funds is by managing the maturities of their investments. Selecting specific maturities does not immediately affect yield since all special issues bear the same rate of interest regardless of maturity. However, the yield earned by the Funds over a longer period of time can be affected depending on the maturity structure of its assets and on how interest rates may change.

In general, a policy of investing in longer-term securities will cause the yield received by the Funds to lag consistently behind current market rates if interest rates are rising over a sustained period of time. This is because the Funds are locked into lower-yielding investments made in earlier years and are unable to take full advantage of the higher rates currently available. On the other hand, if interest rates persistently decline, a policy of investing in long-term securities will produce yields that consistently exceed current market rates.

A policy of investing only in short-term securities will allow the Funds to earn a yield that is always close to the current market rate. This works to the advantage of the Funds during periods when interest rates are persistently rising compared to what would have been earned had the Funds invested in long-term securities. But it works to the disadvantage of the Funds if interest rates persistently decline.

It is legally possible for the Secretary of the Treasury to shift between long-term and short-term investments depending upon the investment outlook. Under a discretionary management approach, the Funds would invest in longer-term securities whenever the outlook for future rates appeared to be stable or declining. Similarly, the Funds would shift to short-term investments whenever interest rates appeared to be headed for an increase. When the outlook was uncertain, a mixed policy might be followed. A discretionary approach could result in yields that are higher or lower than the yields obtained through a fixed policy, depending upon the ability of the Secretary to make correct predictions about the future cour of interest rates.

Despite the legal authority to employ discretion, the Secretary of the Treasury has consistently followed a fixed approach of spreading maturities as equally as possible over a 15-year period. Part of the reasoning behind this approach seems to involve a desire to avoid criticism for making potentially wrong predictions about future interest rate developments. The Treasury also seems worried that the exercise of investment discretion might subject it to accusations that it is deliberately selecting the wrong investments in order to hold down the interest cost of the Treasury. As a result, the Treasury has consistently followed the same policy over the last 21 years regardless of current market conditions or interest rate trends. The Treasury apparently believes that if it follows a fixed policy long enough, the gains and losses will balance out and the Funds will earn a yield comparable to what could have been obtained under discretionary management.

The 15-year maturity policy may have appeared reasonable in the late 1950s when it was first established. The Trust Funds were accruing annual surpluses and it seemed logical to invest them in long-term issues since benefit payments would not be needed for many years into the future. Moreover, long-term rates at the time substantially exceeded short-term rates, and no one was predicting a sustained 20 year rise in the level of interest rates.

Congress went along with the policy in 1960 when it last revised the law by changing the formula for computing the rate of interest paid on special issues. Under the revised formula, only Treasury securities with maturities of more than four years would be counted. Thus, by basing the interest formula on long-term rates, Congress implicitly endorsed the policy of investing exclusively in long-term issues.[1]

With the benefit of hindsight, the 15-year maturity policy has proven to be a fiscal disaster for the Funds. Interest rates have persistently risen over the last two decades and are almost four times higher today than they were 20 years ago. As a result, the yield earned by the Funds has almost always lagged behind current market rates. Only maturing investments and new reserves could be invested at the higher current rates. The bulk of the reserves were locked into lower yielding investments made in past years.

Clearly, the Funds would have been better off by investing only in six-month Treasury bills at current market rates. Had such a policy been followed, the Funds would have earned an additional $11.7 billion in interest payments over the last 21 years.

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[1] Although the 1960 legislation purports to allow the Funds to earn interest at the long-term rate, it does not quite accomplish this objective. In computing the rate on new special issues, the law requires the Secretary to include all issues of more than four years maturity including low-coupon issues trading at deep discounts. Because of their capital gain tax advantages, deep-discount issues have a lower market yield. Including them in the computation lowers the average rate paid. For example, over the last 21 years, the rate on new special issues averaged 6.35 percent while the current market yield on ten-year Treasury bonds trading close to par averaged 6.58 percent.

The experience over the last 21 years suggests that Congress needs to reconsider the present rigid system which offers no protection to the Funds during periods of prolonged inflation and rising interest rates. There are several options Congress might consider in establishing investment policies for the Funds for the next 20 years.

The first would be to continue the present system without major change. This is essentially the Treasury position. The argument made for keeping the current system is that in the long-run it is more likely to produce an equitable return than any alternative system. Just because interest rates have risen over the last two decades doesn't mean that they will necessarily continue to rise over the next two decades. Interest rates may well have reached a historic high.

On the other hand, continuing the present system without change does subject the Funds to the risk of a further erosion of interest earnings if interest rates continue to rise. Over the last few years, how many economists and financial analysts have pronounced that interest rates had peaked, only to be proven wrong?

A second option would be to expand the Board of Trustees and direct it to exercise discretionary investment management in order to maximize the yield of the Funds. This is the approach taken in S. 1528 as I have introduced it. The bill is predicated on the belief that discretionary management should be able to produce yields over time that exceed any fixed investment policy. Congress cannot possibly forsee all future developments in credit markets. Most funds in the private sector are actively managed on a day-to-day basis in order to take advantage of the constantly changing investment outlook.

Nevertheless, the concept of discretionary management has not met with universal acceptance among those who have studied the problem. Some fear that lower yields might be realized if the Board of Trustees consistently made the wrong investment choice. Others are concerned about maintaining public confidence in the soundness of the Social Security System and are worried that confidence might be impaired if it were to be perceived that the Trustees were "speculating" with the reserves of the Funds.

Should the Subcommittee find the discretionary approach infeasible, I would be willing to consider other options designed to give the Funds better protection than the present system. I ~~One~~ recommend that we ~~such option would be to~~ scrap the present system for investing in specific maturities and simply allow the Funds to deposit their reserves in a savings type account maintained at the Treasury. Interest on these deposits would be paid at a rate equal to the current market rate on all Treasury securities. Funds could be deposited in or withdrawn from the Account at any time without penalty. This is essentially the system recommended by the General

Accounting Office when it studied the issue in 1975.

Interest on Fund deposits should be tied to a composite rate on all Treasury securities rather than to any specific short-term or long-term rate. A composite rate is less volatile than either short-term or long-term rates. It also reflects the Treasury's current cost of funds and is an indirect measure of what the Treasury would have to pay if the Social Security Trust Funds were to invest elsewhere.

It could be argued that interest on Fund deposits should be paid at the current short-term rate because the deposits would be available for withdrawal at any time. Since a composite rate includes long-term securities, it will average somewhat higher than short-term rates. For example, over the last 21 years, the composite rate on all Treasury securities averaged 17 basis points higher than the average rate on six-month Treasury bills. (A basis point is equal to one one-hundreth of 1 percent.) Some might therefore conclude that a composite rate constitutes an unwarranted subsidy to the Funds.

It is also true, however, that unlike other pension funds, the Social Security Trust Funds are severely restricted in their investment opportunities. They are essentially limited to investing in Treasury securities even though higher yields could be obtained elsewhere with virtually no additional risk. Moreover, a savings account approach would deny the Funds whatever benefits might be obtained through a discretionary management approach. Therefore, the somewhat higher yield from a composite rate probably only partially compensates the Funds for the denial of these benefits.

The advantages of the savings account approach are that it does away with the present complicated procedures for attempting to keep maturities spread equally over a 15 year period. It avoids any argument over which securities to redeem whenever the Funds must make a withdrawal to meet current benefit payments. It eliminates any need to try to guess which way interest rates may be heading in the future. And above all, it guarantees that the Funds will always earn interest at a rate equal to the Treasury's current cost of money - no more and no less.

In a sense, the present system resembles a savings account since the Treasury stands ready to redeem all special issues at par. However, unlike a true savings account, the rate of interest on special issues is not periodically adjusted to reflect current market rates.

It should be noted that if interest rates decline substantially over the next several years, the savings account approach might earn less interest for the Funds compared to the present system. However, the prospect of additional interest profits must be weighed against the risk of a further erosion in interest earnings if interest rates continue to increase. There is also a real question whether Congress ever intended that the Funds earn speculative interest profits by betting on a favorable downturn in interest rates. The possibility of speculative profits must necessarily include the possibility of speculative losses. If interest rates do, in fact, decline substantially in the next few years, the Funds will be in a much stronger financial condition because of the parallel reduction in inflation.

If the savings account approach had been in effect over the last 21 years ending on June 30, 1981, the Funds would have earned an additional $14.9 billion in interest payments. In no year would the interest earned under the savings account approach have been less than the actual interest received under the current system. If preliminary fiscal year 1982 data are included, the cumulative amount of lost interest will exceed $18.5 billion - an average short fall of over $800 million a year.

The savings account approach could also save the Funds between $1 billion and $1.6 billion in fiscal year 1983 and 1984 based on the financial projections released by the Board of Trustees last April. This estimate assumes that all special issues would be redeemed at par during the first six months of fiscal year 1983. If special issues were held for a longer period, the savings would not be as great.

Mr. Chairman, I am certainly not suggesting that a revision to the investment policies will solve all of the financial problems of the Social Security Trust Funds. Nonetheless, $18.5 billion in lost interest payments over 22 years is not exactly a trivial amount. If the reserves of the Funds were to be increased by $18.5 billion, the Congress might not have to consider all of the difficult measures deemed necessary for restoring the solvency of the Funds.

Obviously, it would not be appropriate to try to compensate the Funds for all of the interest lost by the present system. However, this Subcommittee and the Congress must look to the future. It is clear that the present system is not working. Timely action today can lay the groundwork for a more rational investment policy so that we are not faced with the same problems two decades from now.

Mr. Chairman, I ask unanimous consent that several tables be included in the record at the end of my statement, together with a draft of the savings account approach as an alternative to S. 1528.

Comparision of Yield on Trust Fund Investments with Yield on U.S. Government Obligations 1961 - 1981

	Yield on Treasury Securities				Trust Fund Yield	
Year Ending June 30	6-Month Bills (Investment Yield)	3-Year Notes & Bonds	10-Year Bonds	Composite Yield	Average Yield Received On All Investments	Average Rate on New Special Issues Purchased During The Year
1961	3.01	3.76	4.00	3.51	2.69	3.74
1962	2.83	3.51	3.92	3.33	2.82	3.89
1963	3.17	3.57	3.97	3.54	2.88	3.84
1964	3.58	3.85	4.10	3.82	3.03	4.06
1965	4.00	4.13	4.23	3.95	3.16	4.13
1966	4.74	4.72	4.60	4.69	3.32	4.53
1967	5.05	5.13	4.99	5.06	3.70	4.87
1968	5.25	5.36	5.82	5.43	3.97	5.42
1969	6.45	6.35	6.16	6.35	4.25	5.82
1970	7.04	7.15	7.0[illegible]	7.07	4.89	7.23
1971	5.78	6.47	6.75	6.20	5.39	6.44
1972	4.66	5.69	6.19	5.29	5.50	5.97
1973	6.08	6.33	6.52	6.24	5.65	6.25
1974	7.96	7.38	7.20	7.66	6.13	7.01
1975	7.38	7.65	7.77	7.52	6.66	7.51
1976	5.94	7.13	7.80	6.58	6.87	7.41
1977	5.62	6.73	7.51	6.31	7.03	7.02
1978	6.16	7.42	7.82	7.18	7.27	7.54
1979	9.40	9.02	8.88	9.18	7.58	8.69
1980	11.95	10.73	10.50	11.26	8.33	10.13
1981	13.70	12.84	12.52	13.18	9.07	11.87
Unweighted 1961-81 Average	6.18	6.42	6.58	6.35	5.25	6.35

Source:

Interest rates derived from table B-67, Economic Report of the President, 1982, after adjusting for fiscal year and converting discount rates on 6-month Treasury bills into a bond equivalent yield. Composite rates were derived by weighting the yields on 6-month bills and 3- and 10-year securities by the percentage distribution of privately held government securities with maturities of less than 1 year, 1 to 5 years, and over 5 years, as indicated on table B-81 of the Economic Report of the President. Yields on trust funds were supplied by the Social Security Administration.

Table 1

Table 2

Social Security Trust Fund Investment Performance
Comparison of Actual Results with Alternative Interest Formula
(Dollars in Millions)

	Actual Results Under Current Law			Amount that would have been earned if interest were paid at the current market yield on all government securities			
Year Ending June 30	Average Balance in Fund	Yield	Amount of Interest	Average Balance in Fund	Yield	Amount of Interest*	Additional Interest
1961	22,037	2.69%	592	22,037	3.51%	774	182
1962	21,589	2.82	609	21,771	3.33	725	116
1963	20,216	2.88	582	20,514	3.54	726	144
1964	20,045	3.03	607	20,487	3.82	783	176
1965	20,534	3.16	648	21,152	3.95	835	187
1966	19,537	3.32	648	20,342	4.69	954	306
1967	23,044	3.70	853	24,155	5.06	1,222	369
1968	26,853	3.97	1,066	28,333	5.43	1,538	472
1969	30,001	4.25	1,274	31,953	6.35	2,029	755
1970	35,221	4.89	1,721	37,928	7.07	2,682	961
1971	39,686	5.39	2,141	43,354	6.20	2,688	547
1972	42,246	5.50	2,324	46,461	5.29	2,458	134
1973	44,670	5.65	2,522	49,019	6.24	3,059	537
1974	49,001	6.13	3,002	53,887	7.66	4,128	1,126
1975	52,841	6.66	3,520	58,853	7.52	4,426	906
1976	52,775	6.87	3,625	59,693	6.58	3,928	303
1977	50,201	7.03	3,527	57,422	6.31	3,623	96
1978	46,804	7.27	3,401	54,121	7.18	3,886	485
1979	45,116	7.58	3,420	52,918	9.18	4,858	1,438
1980	44,826	8.33	3,734	54,066	11.26	6,088	2,354
1981	43,049	9.07	3,903	54,643	13.18	7,202	3,299
TOTALS:			43,719			58,612	14,893

*Includes the effect of compounding additional interest from prior years.

Table 3

Projection of Potential Interest Savings Under Alternative Interest Formula (Dollars in Millions)

		Current Law			Alternative Interest Formula		
Projection	Fiscal Year	Average Balance	Yield	Interest	Projected Composite Rate on Government Securities	Interest	Additional Interest
II-A	1983	44,589	9.72	4,332	12.43	5,240	908
	1984	39,142	9.50	3,718	11.13	4,458	740
	Totals			8,050		9,698	1,648
II-B	1983	39,382	9.55	3,762	11.80	4,426	664
	1984	29,508	8.96	2,643	9.83	2,966	323
	Totals			6,405		7,392	987

Notes:

Projection II-A was made by the Board of Trustees of the Social Security Trust Funds in their report of April 1, 1982 and is consistent with the economic assumptions contained in the President's Budget. Projection II-B is a somewhat more pessimistic projection by the Board.

Data on average balance, yield, and interest were derived from the Board of Trustees projections.

The projected composite rate on all government securities is assumed to be equal to the projected rate on new special issues used in the Trustees' report. The average for these two rates over the last 21 years was identical.

The interest paid under the alternative formula for fiscal year 1983 assumes special issues will be redeemed at par gradually throughout the first half of the fiscal year.

97th CONGRESS
2d Session

S. _____

IN THE SENATE OF THE UNITED STATES

Mr. Proxmire introduced the following bill; which was read twice and referred to the Committee on _______________ .

A BILL

To amend the Social Security Act to establish depositary accounts in the Treasury for those portions of the Federal Old-Age and Survivors Insurance Trust Fund, the Federal Disability Insurance Trust Fund, the Federal Hospital Insurance Trust Fund, and the Federal Supplementary Medical Insurance Trust Fund not required to meet current withdrawals, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That (a) section 201 of the Social Security Act is amended by striking out subsections (d), (e), and (f) and inserting in lieu thereof the following new subsections:

''(d) There are hereby created on the books of the Treasury of the United States an account to be known as the Old-Age and Survivors Insurance Depositary Account and an account to be known as the Disability Insurance Depositary Account.

''(e) The Managing Trustee shall deposit that portion of the Federal Old-Age and Survivors Insurance Trust Fund not required to meet current withdrawals from such Trust Fund in the Old-Age and Survivors Insurance Depositary Account and that portion of the Federal Disability Insurance Trust Fund not required to meet current withdrawals from such Trust Fund in the Disability Insurance Depositary Account.

''(f) (1) The Secretary of the Treasury may apply moneys deposited in an account pursuant to subsection (e) in any way in which he is authorized by law to apply moneys in the general fund of the Treasury.

''(2) Moneys deposited in an account pursuant to subsection (e) shall be treated as indebtedness of the United States for purposes of section 3689 of the Revised Statutes (31 U.S.C. 711) and shall earn interest, payable monthly, in an amount equal to the product obtained by multiplying the average balance of moneys in the account for such month by the average yield (expressed as a percentage) of all actively traded marketable obligations of the United States (except obligations trading at a substantial discount) held by private investors during such month.

''(3) The Managing Trustee may withdraw moneys deposited in an account pursuant to subsection (e) whenever he determines that such moneys are necessary to meet current withdrawals from the Trust Fund from which such moneys were deposited, and the Secretary of the Treasury may sell obligations of the United States in the market in an amount not to exceed the amount of such withdrawal if he determines that the sale of such securities is necessary to replace moneys withdrawn by the Managing Trustee.''.

(b) Section 1817 of such Act is amended by striking out subsections (c), (d), and (e) and inserting in lieu thereof the following new subsections:

''(c) There is hereby created on the books of the Treasury of the United States an account to be known as the Hospital Insurance Depositary Account.

''(d) The Managing Trustee shall deposit that portion of the Federal Hospital Insurance Trust Fund not required to meet current withdrawals from such Trust Fund in the Hospital Insurance Depositary Account.

''(e) (1) The Secretary of the Treasury may apply moneys deposited in the account pursuant to subsection (d) in any way in which he is authorized by law to apply moneys in the general fund of the Treasury.

''(2) Moneys deposited in the account pursuant to subsection (d) shall be treated as indebtedness of the United States for purposes of section 3689 of the Revised Statutes (31 U.S.C. 711) and shall earn interest, payable monthly, in an amount equal to the product obtained by multiplying the average balance of moneys in the account for such month by the average yield (expressed as a percentage) of all actively traded marketable obligations of the United States (except obligations trading at a substantial discount) held by private investors during such month.

''(3) The Managing Trustee may withdraw moneys deposited in the account pursuant to subsection (d) whenever he determines that such moneys are necessary to meet current withdrawals from the Trust Fund, and the Secretary of the Treasury may sell obligations of the United States in the market in an amount not to exceed the amount of such withdrawal if he determines that the sale of such securities is necessary to replace moneys withdrawn by the Managing Trustee.''.

(c) Section 1841 of such Act is amended by striking out subsections (c), (d), and (e) and inserting in lieu thereof the following new subsections:

''(c) There is hereby established on the books of the Treasury an account to be known as the Supplementary Medical Insurance Depositary Account.

''(d) The Managing Trustee shall deposit that portion of the Federal Supplementary Medical Insurance Trust Fund not required to meet current withdrawals from such Trust Fund in the Supplementary Medical Insurance Depositary Account.

''(e) (1) The Secretary of the Treasury may apply moneys deposited in the account pursuant to subsection (d) in any way in which he is authorized by law to apply moneys in the general fund of the Treasury.

''(2) Moneys deposited in the account pursuant to subsection (d) shall be treated as indebtedness of the United States for purposes of section 3689 of the Revised Statutes (31 U.S.C. 711) and shall earn interest, payable monthly, in an amount equal to the product obtained by multiplying the average balance of moneys in the account for such month by the average yield (expressed as a percentage) of all actively traded marketable obligations of the United States (except obligations trading at a substantial discount) held by private investors during such month.

''(3) The Managing Trustee may withdraw moneys deposited in the account pursuant to subsection (d) whenever he determines that such moneys are necessary to meet current withdrawals from the Trust Fund, and the Secretary of the Treasury may sell obligations of the United States in the market in an amount not to exceed the amount of such withdrawal if he determines that the sale of such securities is necessary to replace moneys withdrawn by the Managing Trustee.''.

(d) (1) Not later than 180 days after the date of enactment of this Act, the Secretary of the Treasury shall redeem at par all outstanding obligations of the United States issued under the Second Liberty Bond Act exclusively for purchase by the Federal Old-Age and Disability Trust Fund, the Federal Disability Insurance Trust Fund, the Federal Hospital Insurance Trust Fund, and the Federal Supplementary Medical Insurance Trust Fund (hereinafter in this subsection referred to as the ''Trust Funds'').

(2) The Managing Trustee may sell any marketable obligation of the United States held by the Trust Funds at market price at any time.

(3) The proceeds from the redemption and sale of obligations of the United States pursuant to paragraphs (1) and (2) shall be paid to the Trust Fund selling or redeeming such obligations and that portion of such proceeds which is not required to meet current withdrawals from such Trust Fund shall be deposited in the account established with respect to such Trust Fund by subsection (a), (b), or (c) of this Act.

(e) Paragraph (1) of subsection (g) of section 217 of the Social Security Act is amended to read as follows:

''(1) In October of every fifth year beginning with October 1980, up to and including October 2010, the Secretary shall determine the amount which, if paid in equal installments at the beginning of each fiscal year in the period beginning with the beginning of the first fiscal year commencing after the determination, and ending with the close of September 30, 2015, would accumulate, with interest compounded annually, to an amount equal to the amount needed to place each of the Trust Funds and the Federal Hospital Insurance Trust Fund in the same position at the close of September 30, 2015, as he estimates they would otherwise be in at the close of that date if section 210 of this Act as in effect prior to the Social Security Act Amendments of 1950, and this section, had not been enacted. The rate of interest to be used in determining such amount shall be the rate determined under section 201 (f) (2) in the September preceding the October in which the determination is made.''.

(f) The amendments made by this Act shall take effect on October 1, 1982.

Senator ARMSTRONG. We will include the material in the record. We are grateful to have it. We appreciate very much your statement. Let me inquire about your time. Would it be convenient for you to hear from Mr. Stennis and Mr. Shamansky, and then have some discussion?

Senator PROXMIRE. Yes, indeed. I would be delighted to do that, of course.

Senator ARMSTRONG. Well, if that is agreeable to the committee then, I would recognize next our colleague from Mississippi, Mr. Stennis, who has had a long-standing interest in this problem, and we are eager to hear your statement.

STATEMENT OF HON. JOHN C. STENNIS, A U.S. SENATOR FROM THE STATE OF MISSISSIPPI

Senator STENNIS. Mr. Chairman and Senator Dole, I really appreciate being here this afternoon.

The facts and figures that I could relate would be almost identical to those cited by the Senator from Wisconsin. I would rather take this time to express my belief that we are certainly going to have to take some action in this field to correct the existing problems. We are very clearly dealing with trust funds. They are not the property of the general fund of the Treasury even though we have responsibility in connection with them. They are trust funds, and we are trustees, and we have abused that trust. I am not here to prosecute anyone, of course, or even to criticize anyone. However, the existing conditions must be remedied.

I have recently been in 80 of 82 counties in my home State and have talked to people by the hundreds. They bring up the subject of social security far more than any other one subject. Many of them just walk up to me and address me by my name, some that know me and some that don't, and say that we just—these are people that are still paying—we just do not believe that we will ever get back our money.

Now, that is a serious thing, gentlemen, and it is pronounced, and it is gradually spreading. These are not just skeptics. They are people with the deepest concern. In addition, the people who are receiving payments are concerned about proposed reductions. However, I am talking about the entire system. As soon as I found out how it operated, I never did subscribe to the idea of making social security a part of the overall budget. In addition, I voted against a great many of the benefits that have been added over the years. I don't claim any credit for that. We didn't have the money to pay for them. I voted for the tax increases, though, particularly the increase adopted in 1977. I said it was absolutely necessary to protect the fund. Knowing that it was a trust fund, belonging to someone else, entrusted to the Government, I voted for the increases which were necessary.

Now, we are challenged on all sides. I think we absolutely must do something about this now, not tomorrow. It can't be done rapidly, but it must be worked out, and the Finance Committee, for which I have a very high regard, and based on its many years of constructive contributions, could not work on a better item than the investment of social security trust funds. There is a misunderstanding. There is a weakening of the essential spirit of trust and confidence that has to go with any successful government. It is challenged. It is affecting the minds of the people, the other elements, and other problems. This is one thing that we could choose to take action on to restore its soundness, to the extent that the money is available to pay the benefits. We could then gradually trim the deficit so that the trust funds would eventually stand on their own feet for some considerable number of years ahead.

Now, I think time is running out, and I hope you can make a thorough study of this entire problem and initiate something that will bring this more in line with the realities. The realities are that whatever this money earns belongs to the fund and it should earn as much as is prudently possible.

I had a letter from a complaining constituent when I first came here saying it was not being handled right. Well, I looked into it, and thought it was. But I found out I did not fully go into all the details and ramifications. So, I am willing to vote for most anything that I think will put this whole problem on a sound basis and restore the confidence of the people in it, and make it a going concern.

I ask consent, Mr. Chairman, that the remainder of my remarks be placed in the record at this time. If the committee will report out a bill, I pledge now to go down the line for it if it eliminates the existing problems. I intend to get some definite figures on this matter. I have a bill to require the paying into this fund out of the Federal Treasury of a sum that is calculated to be the equivalent of what more alert management, better management would have provided. I will introduce this bill soon. That is no reflection on any preceding officer or anything of that kind.

I thank you very much.

[The prepared statement of Senator Stennis follows:]

Statement
by
SENATOR JOHN C. STENNIS
before

SUBCOMMITTEE ON SOCIAL SECURITY AND INCOME MAINTENANCE PROGRAM

COMMITTEE ON FINANCE, UNITED STATES SENATE

June 8, 1982

Mr. Chairman and members of the Subcommittee, I appreciate very much the opportunity to be with you today to discuss some of the important issues involving Social Security trust funds. My specific purpose today is to discuss Social Security trust fund investment policies in general and the bill which I have introduced, S. 1768, in particular.

The purpose of S. 1768 is to make it mandatory that Social Security trust funds not required to meet current withdrawals be invested in government securities or obligations so as to secure the maximum possible interest yield commensurate with the safety of the investment. I will discuss briefly why I think this legislation is necessary and desirable.

The Social Security Act now provides that the assets of the three trust funds are to be invested solely in United States government obligations. The law provides that they shall be invested in special public-debt obligations of the United States except in those cases where the Managing Trustee -- the Secretary of the Treasury -- expressly determines that the purchase of other government securities is in the public interest. It is thus clear that Social Security trust funds can be invested either in special issues or in any other government securities.

About 90 percent of the available Social Security trust fund balances are now invested in non-marketable, 15-year special issue Treasury securities which are sold only to the trust funds. Yields on these securities are set by law at the average yield on all outstanding Treasury securities maturing four or more years after the special securities are issued. In practice, this formula has yielded rates which, while changing with overall federal borrowing costs at the time of issue, are set below the yields paid on federal securities of comparable maturities.

On June 30, 1980, there was approximately $47 billion in the Social Security trust funds. The interest earned during calendar year 1980 was the not insignificant sum of $3.85 billion. However, the combined rate of earnings for the trust funds involved for the year ending June 30, 1980, was only 8.3 percent. As we all know, at that time other government or government-backed securities were earning about 13.5 percent. A year later they were earning about 16 percent.

Despite the fact that securities having substantially higher yields were available, over 90 percent of the trust funds were invested in the special issues. In 1980 most of these special issues carried an interest rate of 7 percent. Only $6.3 billion of these special issues carried an interest rate in the range of 9 percent.

The fact is that, if the trust funds had been invested in government or government-backed securities paying the maximum yield in 1980 and 1981, the trust funds would have earned each year about $2 billion more than they actually earned. The 1980 difference is equal to about 60 percent of the $3.3 billion combined deficit that the trust funds suffered in that year. Investment of new receipts in securities with higher rates of interest after that time increased the yield on the trust fund investment but only to an annualized rate of 10.8 percent as of September 30, 1981.

In addition, according to a Department of the Treasury estimate, if during the 1960-1980 period the special issues held by the trust funds on June 30 of each year that carried an interest rate lower than the interest rate for the new issues in June had been reinvested (or rolled over) in special issues carrying the new and higher interest rate, the assets of the Old-Age and Survivors Insurance and Disability Insurance trust funds would have increased by about $13.5 billion. It is to be noted that this figure does not include the Hospital Insurance trust fund.

This situation disturbed me and shocked me. It seems clear to me that the low rate of return on these trust funds was by design and not by accident. Instead of trying to maximize the return on the Social Security trust funds the ~~effort~~ result has been to minimize the return and thus reduce the interest paid on the national debt.

These trust funds are dedicated for the payment of Social Security benefits. Those who hold and invest them act in a fiduciary relationship of the highest nature. As such, it is essential, in my judgment, that the funds be invested so as to earn the maximum return commensurate with the safety of the investment.

This is particularly true in view of the financial difficulties with which the Social Security program is now confronted. We must take all actions which are available and practicable to enhance Social Security funding. This includes taking steps to ensure that the trust funds earn what the market will safely bring. By paying a lesser rate of interest than was otherwise available, the result has been to enrich the general fund of the government at the expense of the Social Security trust funds.

This is a situation that should not be countenanced. This is not money owned by the United States government. Present and future retirees are entitled to the assurance that their trust funds are safe and secure and will be available in sufficient amount to pay the benefits which the law provides as and when they become due.

I believe that S. 1768 should be reported out by the Committee and enacted into law. It would contribute to the solvency of the Social Security system. It is a mistake to prefer general fund obligations and interest payments over the best interests of the Social Security fund assets. The trustees must recognize the fiduciary nature of their actions and make every effort as prudent businessmen to increase the return to the Social Security trust funds.

In closing, I would like to advise the Subcommittee that I have had prepared and will shortly introduce other legislation dealing with the trust fund situation. As I have indicated, I feel that the general fund in the Treasury has been unjustly enriched at the expense of the Social Security trust funds and at the expense of Social Security beneficiaries. Therefore, I will introduce legislation to require that the Social Security trust funds be reimbursed from the general fund of the Treasury the amount which the Social Security trust funds have been shortchanged because the trust funds have been invested in government securities which have provided a lesser rate of return than was otherwise available. I hope that the Subcommittee will give this legislation serious and prompt consideration when it is introduced.

Senator ARMSTRONG. Thank you, Mr. Stennis.

The committee would, if it is agreeable to you, we would like to go ahead and hear Congressman Shamansky, and then perhaps we could have some discussion.

Senator STENNIS. Yes, I am delighted.

Senator ARMSTRONG. It appears that the three witnesses have three fundamentally different approaches to increasing the yields available to the trust fund. Senator Proxmire proposes what amounts to a formula approach. You have recommended discretion for the trustees, and as I understand it from his written presentation, Mr. Shamansky will suggest in effect taking the trustees out of the business of portfolio management altogether.

In any event, we are delighted to welcome Congressman Shamansky of Ohio to the committee, and we are very eager to hear his statement.

STATEMENT OF HON. BOB SHAMANSKY, A U.S. REPRESENTATIVE FROM THE STATE OF OHIO

Representative SHAMANSKY. Thank you, Mr. Chairman.

Because these two illustrious gentlemen on either side of me have touched upon many of the points that I would have made, I will just paraphrase the beginning of my written testimony, which you already have and which I would appreciate being put in the record.

What compelled me to look into this matter was my learning that in 1980 the combined earnings of the $47 billion in the trust funds was a shockingly low 8.3 percent. Others investing exclusively in Government or Government-backed securities earned as much as 13.5 percent. This trend of poor earnings continued in 1981. None of the three funds earned a return on its investments higher than 8.9 percent. Financial institutions investing exclusively in Government or Government-backed securities in 1981 frequently earned over 14 percent on their investments. The average yield on 6-month U.S. Treasury bills in 1981 was 14.09 percent.

Very frankly, what it looks like, from the viewpoint of the beneficiary, namely, the person who is entitled to a social security payment, is that these funds are being managed for the benefit of the Treasury, and not for the benefit of the beneficiaries of the funds.

If you are a lawyer, as I am, that is a conflict of interest. The Secretary of the Treasury, it would appear, and his committee, in effect, have been more concerned to keep down the expenditure of the Treasury than they have been in maximizing the return for the beneficiaries. Frankly, that is not the Anglo-American approach to fiduciary law, and a situation like that is called a conflict of interest.

I have introduced a bill in the House, H.R. 5987, referred to as the Social Security Trust Funds Improvement Act of 1982. My bill would, one, insure that the trust funds earn a fair yield; two, insure that the trust funds earn a yield that is consistent with the cost of money to the Treasury from the public at any given moment; three, restore public confidence in the investments of the trust fund; four, simplify the system; and five, reduce the costs and manpower associated with operating the system.

First, this bill would create an account for each trust fund, which would earn interest like a savings account. This is somewhat along the line that Senator Proxmire has suggested. This would eliminate the need for special issues, maturities, redemptions, redemption without penalty, and so forth. In that sense, the funds would be taken out of the management of an investment portfolio. We would have a much less complicated thing to manage.

Second, the bill would require that the yield to the funds be the higher of two statutorily determined formulas. To the extent that any of the gentlemen here are lawyers, lawyers like precedents. Right now, the law already provides for the yield to be calculated on that, the yield for those maturing beyond 4 years. Well, I am not changing that aspect. That would be one of the two formulas. The other essentially would be that for up to 4 years, to try to provide or make accommodation for the rising rates that we have now that make short term a much more important thing.

In other words, one, the existing formula is the rate of interest equal to the average market yield on all marketable interest-bearing obligations of the U.S. Government which are not due for at least 4 years; the other, weighted toward short-term rates, will be the rate of interest equal to the average yield on all marketable interest-bearing obligations of the U.S. Government which are due in less than 4 years.

This is our attempt to get the necessary flexibility. In this way, we insure that the social security trust funds earned a yield that is up to date, and insure public confidence in the management of the system. The yield is similar to that which Treasury pays the public to borrow money, though it assumes a measure of wisdom on the part of the managing trustee, unlike the current system which assumes total ignorance.

I know some questions have been raised about assuming wisdom on the part of Government investment, some cynics question assuming the wisdom of anything that the Government does. I am not one of those. I have been asked if the two-tier system I propose is not an unwarranted subsidy to the trust funds. I strongly maintain that it is not. In any event, it is certainly better than the present practices which have the trust funds subsidizing the Treasury.

First, there is strong evidence to suggest that the current system of investing the trust funds has worked to the disadvantage of social security for some time, perhaps even when interest rates were low, or even stable. According to the Government Accounting Office report published January 10, 1975, the interest rates assigned to trust fund investments over the previous 5 years were less than the yield rates of outstanding marketable securities of comparable maturity.

The Treasury was saving money and the trust funds were losing. There is at least one clear bias in the formulas currently used to determine yields for the trust funds. Some of the obligations included in the formulas offer tax advantages which tend to increase the bid price and lower the yield on such issues below the interest rate the Government would have to pay on new issues. Again, the trust funds suffer.

Second, though it is very difficult to determine what is a fair return of the trust fund on its lending to the Treasury, there is ample evidence that it was intended that the trust funds receive the benefit of the doubt. In 1935, at the inception of the program, Congress assigned a fixed interest rate of 3 percent per annum compounded annually to the trust fund investments. The rate of 3 percent provide in the original act was greater than the yield of Treasury public issues which did not rise above 3 percent during the next 20 years.

Possibly this "subsidy," and I put that in quotation marks, was a recognition of the advantages to the Treasury and the economy of reducing the need of the Treasury to borrow from the public, as noted in the report of the House Ways and Means Committee on its 1935 social security bill. This benefit of the doubt to the trust funds is present in other ways in the current investment system. The 1956 amendment provided that: "The trust funds should have maturities fixed with due regard for the needs of the trust funds." A procedure was adopted for fixing maturities to lessen the adverse impact on the trust funds of changes which had taken place in the Treasury securities market.

The 1956 amendments also eliminated short-term obligations from the computation for determining the yield for special issues. It was predicted that this change would eventually earn the trust funds an additional $160 million per year. Thus, there is a long tradition of letting the break fall to social security and not against it, as has been the recent case.

Perhaps the most appealing feature of the bill, I believe, is the pleasant simplicity it brings to the now bizarre investment practices. The trust fund investments would become comprehensible to the public, an important step toward building public confidence, or I should say rebuilding public confidence. Without the current system of issues, maturities, and redemptions, the system would be more manageable and less expensive to administer. Frankly, it is difficult to determine to what extent the trust funds are being treated unfairly over the long run, but long run is itself a tricky concept. Depending upon the time period one chooses, results can, of course, be very different indeed.

What is clear is that the trust funds do suffer during periods of rising interest rates because the existing system of investing trust fund assets is not designed for periods of fluctuating interest rates, or for periods in which special issues are regularly required to be redeemed earlier. Still clearer and more important is the effect the current system has on public perception. Unless our economy soon returns to a period of very stable interest rates, which seems highly unlikely, the earnings of the trust funds will continue to be a concern to the public. It is imperative that we design a system of investment that insures that the trust funds always earn a yield that is up to date. Public confidence in the system is important not just for today, but for years to come. We cannot afford to have the social security trust funds earn shockingly low yields. We can insure a fair yield that is up to date without asking the Treasury to provide a subsidy to the trust funds. It is time to adapt to the economic realities of volatile interest rates and reform the investment practice of the Social Security Trust Funds.

Thank you very much.

[The prepared statement of Congressman Bob Shamansky follows:]

Testimony of Congressman Bob Shamansky

Mr. Chairman, I appreciate the opportunity to testify before this committee on the important issue of the investment practices of the social security trust funds. There has been a great deal of public concern about the investment practices of the trust funds because of the low-earnings reported over the last several years. At a time when the social security system is facing financial difficulties, these low yields on trust fund investments are particularly unjustifiable.

I am sure this committee is familiar with the relevant figures: in 1980, the combined earnings of the $47 billion in the trust funds was a shockingly low 8.3 percent. Others investing exclusively in government or government-backed securities earned as much as 13.5 percent. This trend of poor earnings continued in 1981. None of the three funds earned a return on its investments higher than 8.9 percent. Financial institutions investing exclusively in government or government-backed securities in 1981 frequently earned over 14 percent on their investments. The average yield on 6-month U.S. Treasury Bills in 1981 was 14.09 percent.

Although the interest income of the social security program is not a major factor in its financing, it is not insignificant in absolute terms. In calendar year 1980, the interest income of the four trust funds was only 2.46 percent of the total income. However, such interest income amounted to $3.85 billion, which was 1.5 times as large as the

ADMINISTRATIVE EXPENSES OF THE PROGRAM.

MORE IMPORTANT IS THE EFFECT EARNINGS HAVE UPON PUBLIC CONFIDENCE AND PUBLIC PERCEPTION. THE AMERICAN PEOPLE, SHOCKED BY RUMORS OF A BANKRUPT SOCIAL SECURITY SYSTEM, A SYSTEM THAT WILL BE UNABLE TO MEET ITS OBLIGATIONS, IS CONCERNED. THEY WONDER AT THE INTEGRITY AND ABILITY OF THOSE IN THE FEDERAL GOVERNMENT WHEN THEY HEAR THE FUND'S ANNUAL YIELD IS ABOUT 8 PERCENT; THE PUBLIC MAY BE EARNING 13 AND 14 PERCENT IN MONEY MARKET FUNDS DURING THIS SAME PERIOD.

PUBLIC CONFIDENCE IS ESSENTIAL TO THE FUNCTIONING OF ANY DEMOCRATIC GOVERNMENT; IT IS PARTICULARLY IMPORTANT TO THE FUNCTIONING OF A SYSTEM LIKE SOCIAL SECURITY WHICH ASKS THE PUBLIC TO CONTRIBUTE TODAY FOR BENEFITS IT WILL RECEIVE IN THE DISTANT FUTURE. POLLS INDICATE THAT THE MAJORITY OF AMERICANS DO NOT HAVE CONFIDENCE IN THE SOCIAL SECURITY SYSTEM AND DO NOT BELIEVE BENEFITS WILL BE AVAILABLE TO THEM WHEN THEY RETIRE. THIS IS A PERCEPTION WE IN CONGRESS MUST CORRECT.

THERE ARE A NUMBER OF THINGS CONGRESS COULD DO TO IMPROVE THE EARNINGS OF THE TRUST FUNDS. OUR GOAL MUST BE TO INSURE THAT THE TRUST FUNDS EARN A FAIR RETURN ON THEIR INVESTMENTS. THE TREASURY SHOULD NOT SUBSIDIZE THE TRUST FUNDS, BUT BY THE SAME TOKEN, THE TRUST FUNDS SHOULD NOT SUBSIDIZE THE TREASURY. THE PAYMENTS MADE BY THE TREASURY ON ITS BORROWINGS FROM SOCIAL SECURITY SHOULD RESEMBLE THE AMOUNT PAID ON PUBLIC BORROWINGS. THE TREASURY SHOULD NOT BE USING ITS BORROWINGS FROM

SOCIAL SECURITY AS A WAY OF HOLDING DOWN THE PUBLIC DEBT. WE MUST BE FAIR TO SOCIAL SECURITY WITHOUT BEING UNFAIR TO THE TREASURY, AND WE MUST ELIMINATE THE PERCEPTION OF GOVERNMENT MISMANAGEMENT AND FOR CONFLICT OF INTEREST WITH REGARDS TO THE TRUST FUNDS.

CURRENT SOCIAL SECURITY INVESTMENT PRACTICES ARE NOT SUITED FOR THE DEMANDS BEING PLACED UPON THE SYSTEM OR FOR PRESENT-DAY ECONOMIC CONDITIONS. THE RESULTS ARE LOW-YIELDS WHICH WEAKEN PUBLIC CONFIDENCE. WHEN THE SYSTEM WAS ESTABLISHED IN 1935, THE TRUST FUNDS WERE SEEN AS A CUSHION, A "MARGIN OF SAFETY" AGAINST OBLIGATIONS OF THE SYSTEM. IT WAS NOT EXPECTED THAT THE TRUST FUNDS WOULD HAVE TO BE DRAWN ON TO MEET CURRENT SOCIAL SECURITY OBLIGATIONS. ACCORDINGLY, THE TWO LARGEST TRUST FUNDS — OLD AGE AND SURVIVORS INSURANCE (OASI) AND DISABILITY INSURANCE (DI) — HAD ASSETS EQUAL TO 200 PERCENT OF FISCAL OUTLAYS IN 1960. BY 1970 THIS FIGURE HAD DROPPED TO 105 PERCENT. DURING THE NEXT TEN YEARS, THE FUNDS CONTINUED TO BE DRAWN UPON TO MEET CURRENT SOCIAL SECURITY OBLIGATIONS. IN 1980 THE FUNDS HAD ONLY 23 PERCENT OF THAT YEAR'S OUTLAYS. THE MARGIN OF SAFETY WAS GONE. EVEN IF THEY BORROW FROM EACH OTHER, THE THREE FUNDS MAY BE EXHAUSTED BY 1985.

ALSO, THROUGHOUT THE HISTORY OF THE SOCIAL SECURITY SYSTEM, INTEREST RATES HAVE BEEN FAIRLY STATIC. INVESTMENT PROCEDURES WERE PREDICATED UPON STATIC INTEREST RATES AND ARE NOT SUITED TO THE FLUCTUATING RATES THAT WE RECENTLY HAVE EXPERIENCED AND IN ALL LIKELIHOOD WILL CONTINUE TO EXPERIENCE FOR SOME TIME TO COME.

LET ME ILLUSTRATE: THE TRUST FUNDS ARE CURRENTLY INVESTED IN SPECIAL ISSUES WRITTEN EXPRESSLY FOR THEM BY THE TREASURY. THESE ISSUES ARE ASSIGNED A STATUTORIALLY DETERMINED YIELD AND A FIXED DATE OF MATURITY, THOUGH THERE IS NO PENALTY FOR EARLY REDEMPTION. (THIS REDEMPTION-AT-PAR FEATURE IS AN UNUSUAL AND VALUABLE OPTION NOT AVAILABLE TO OTHER PURCHASERS OF FEDERAL SECURITIES WHICH DISTORTS THE EARNINGS OF THE TRUST FUNDS.) YIELDS TO THE ISSUES ARE WEIGHTED IN FAVOR OF LONG-TERM RATES, WHICH HAVE BEEN TRADITIONALLY HIGHER THAN SHORT-TERM RATES. ONLY IN 7 OF THE LAST 22 YEARS WAS THE RATE ON 6-MONTH T-BILLS HIGHER THAN THE SPECIAL ISSUE RATE. RECENTLY, HOWEVER, BEING WEIGHTED TOWARDS LONG-TERM RATES HAS BEEN A GREAT DISADVANTAGE, SINCE SHORT-TERM RATES HAVE SOARED ABOVE LONG-TERM RATES.

AT THE TIME OF PURCHASE, MATURITIES FOR THAT YEAR'S ISSUES ARE SPREAD OVER A 15 YEAR PERIOD. WHEN THEY ARE REDEEMED, THOSE OF THE NEAREST MATURITY DATE EARNING THE LOWEST YIELD ARE REDEEMED FIRST, INSTEAD OF REDEEMING THE ISSUES WITH THE LOWEST YIELD FIRST REGARDLESS OF MATURITY DATE. THIS PROCEDURE DOES NOT INSURE THAT THOSE WITH THE LOWEST INTEREST RATE WILL BE REDEEMED FIRST. AS A RESULT, WHEN THE TRUST FUNDS ARE BEING DRAWN UPON TO MEET OBLIGATIONS, AND SPECIAL ISSUES ARE BEING REDEEMED EARLY, THE YIELD SUFFERS (ASSUMING RISING INTEREST RATES). THE CONVERSE MAY BE TRUE DURING PERIODS OF FALLING INTEREST RATES. IN EITHER CASE, THE YIELD TO THE TRUST FUNDS IS NOT CONSISTENT WITH THE COST OF PUBLIC BORROWING TO THE TREASURY.

Under different economic circumstances, the existing system is appropriate: issues need not be redeemed "early," low-yielding issues are not kept while high-yielding issues are sold, and the fluctuations in rates are not so great. When interest rates are rising or falling significantly, returns to the trust funds are affected and distorted. Returns are inconsistent with contemporary costs of money.

The current system is misleading; it gives the appearance of being similiar to the investment practices of a fund managed by private managers. In reality, it does not function like a private fund at all. It does not shop around for issues, but has the Treasury write special issues. The managers do not try to anticipate the direction of interest rates, but set maturities in a mechanical fashion. The managers do not redeem the lowest earning issues first, but mechanically go up the list, redeeming whatever issue is next in line. The yield to the funds suffers as a result.

Others have suggested making the trust fund investments more like private investments. Let the trust funds invest in private securities, either bonds or stocks, they say. Invest the funds in social and economic activities such as the construction of housing and hospitals, they suggest. The case against such a loosening of investment sources is compelling. It would be unwise for the Federal Government to control a considerable portion of the private industrial economy by its capital investments and equally unwise for the Federal Government to be setting itself up as a rating organization of securities. Also, recent trends

SUGGEST THAT TRUST FUND INVESTMENTS NEED BE MORE LIQUID THAN THEY WOULD BE WERE THEY INVESTED IN CONSTRUCTION PROJECTS.

OTHERS HAVE SUGGESTED KEEPING THE CURRENT RESTRICTIONS ON TYPES OF INVESTMENT, BUT ENCOURAGING THE MANAGING TRUSTEES TO INVEST MORE "AGGRESSIVELY," MORE LIKE A PRIVATE MONEY MANAGER INVESTS. I AM QUITE CONFIDENT THAT THE SECRETARY OF THE TREASURY — INDEED, ANY FEDERAL EMPLOYEE — WOULD RESIST THE RESPONSIBILITY FOR MAKING DECISIONS REGARDING THE INVESTING OF FUNDS UPON WHICH THE RETIREMENT INCOME OF THE AMERICAN PUBLIC IS DEPENDENT. NO ONE WOULD WANT NOR SHOULD HAVE THAT RESPONSIBILITY.

AS AN ILLUSTRATION, I REFER TO A LETTER FROM THE DEPARTMENT OF TREASURY DATED SEPTEMBER 15, 1981:

> "IN OTHER WORDS, WE THINK IT WOULD BE A VIOLATION OF THE SECRETARY'S MANAGING-TRUSTEE RESPONSIBILITIES TO "PLAY THE MARKET" WITH THE SOCIAL SECURITY TAXPAYERS' FUNDS."

WHEN CONSIDERING REFORMING THE SOCIAL SECURITY TRUST FUNDS INVESTMENT PRACTICES, WE MUST BE AWARE OF REALISTIC LIMITATIONS: RESTRICTED TYPES OF INVESTMENT, AND THE ABSENCE OF STRATEGY AND THE CORRESPONDING RESPONSIBILITY. WE MUST CREATE A SYSTEM IN WHICH THERE IS NO NEED FOR RISK-TAKING, NO POTENTIAL FOR CONFLICT-OF-INTEREST, AND WHICH RESULTS IN FAIR YIELDS TO THE TRUST FUNDS AND YIELDS WHICH ARE CONSISTENT WITH THE COST OF MONEY TO THE TREASURY AT ANY GIVEN TIME.

To that end, I have introduced in the House HR 5987, the "Social Security Trust Funds Improvement Act of 1982." My bill would:

1) insure that the trust funds earn a fair yield
2) insure that the trust funds earn a yield that is consistent with the cost of money to the Treasury from the public at any given moment
3) restore public confidence in the investments of the trust fund
4) simplify the system
5) reduce the costs and manpower associated with operating the system.

First, this bill would create an account for each trust fund, which would earn interest like a savings account. This would eliminate the need for special issues, maturities, redemptions, redemption-without-penalty, and so forth.

→ Second, this bill would require that the yield to the funds be the higher of two statutorially determined formulas. ① One, the existing formula, is the rate of interest equal to the average market yield on all marketable interest-bearing obligations of the U.S. Government which are not due for at least 4 years. The other, weighted towards short-term rates, will be the rate of interest equal to the average yield on all marketable interest bearing obligations of the U.S. Government which are due in less that 4 years.

→ In this way, we insure that the Social Security trust funds earn a yield that is up-to-date — and insure public confidence in the

MANAGEMENT OF THE SYSTEM. THE YIELD IS SIMILIAR TO THAT WHICH TREASURY PAYS THE PUBLIC TO BORROW MONEY, THOUGH IT ASSUMES A MEASURE OF WISDOM ON THE PART OF THE MANAGING TRUSTEE, UNLIKE THE CURRENT SYSTEM WHICH ASSUMES TOTAL IGNORANCE.

I KNOW SOME QUESTIONS HAVE BEEN RAISED ABOUT ASSUMING "WISDOM" ON THE PART OF GOVERNMENT INVESTMENT -- SOME CYNICS QUESTION ASSUMING THE PRESENCE OF WISDOM IN ANYTHING THE GOVERNMENT DOES I'm not one of those. I'VE BEEN ASKED IF THE TWO-TIER SYSTEM I PROPOSE IS NOT AN UNWARRANTED SUBSIDY TO THE TRUST FUNDS. I STRONGLY MAINTAIN THAT IT IS NOT. IN ANY EVENT, IT IS CERTAINLY BETTER THAN THE PRESENT PRACTICES WHICH HAVE THE TRUST FUNDS SUBSIDIZING THE TREASURY.

FIRST, THERE IS STRONG EVIDENCE TO SUGGEST THAT THE CURRENT SYSTEM OF INVESTING THE TRUST FUNDS HAS WORKED TO THE DISADVANTAGE OF SOCIAL SECURITY FOR SOME TIME -- PERHAPS EVEN WHEN INTEREST RATES WERE LOW ~~AND~~ or even STABLE. ACCORDING TO A GAO REPORT PUBLISHED JANUARY 10, 1975, THE INTEREST RATES ASSIGNED TO TRUST FUND INVESTMENTS OVER THE PREVIOUS FIVE YEARS WERE LESS THAN THE YIELD RATES OF OUTSTANDING MARKETABLE SECURITIES OF COMPARABLE MATURITY. THE TREASURY WAS SAVING MONEY AND THE TRUST FUNDS WERE LOSING. THERE IS AT LEAST ONE CLEAR BIAS IN THE FORMULAS CURRENTLY USED TO DETERMINE YIELDS FOR THE TRUST FUNDS: SOME OF THE OBLIGATIONS INCLUDED IN THE FORMULAS OFFER TAX ADVANTAGES WHICH TEND TO INCREASE THE BID PRICE AND LOWER THE YIELD ON SUCH ISSUES BELOW THE INTEREST RATE THE GOVERNMENT WOULD HAVE TO PAY ON NEW ISSUES. AGAIN THE TRUST FUNDS SUFFER.

Second, though it is very difficult to determine what is the fair return to the trust funds on its lendings to Treasury, there is ample evidence that it was intended that the trust funds receive the benefit of the doubt. In 1935, at the inception of the program, Congress assigned a fixed interest rate of 3 percent per annum compounded annually to the trust fund investments. The rate of 3 percent provided in the original act was greater than the yield of Treasury public issues which did not rise above 3 percent during the next 20 years. Possibly this "subsidy" was a recognition of the advantages to the Treasury and the economy of reducing the need of the Treasury to borrow from the public, as noted in the report of the House Ways and Means Committee on its 1935 social security bill.

This "benefit-of-the doubt" to the trust funds is present in other ways in the current investment system. The 1956 amendments provided that, "...the Trust funds should have maturities fixed with due regard for the needs of the Trust Funds...." A procedure was adopted for fixing maturities to lessen the adverse impact on the Trust Funds of changes which had taken place in the Treasury securities market. The 1956 amendments also eliminated short-term obligations from the computation for determining the yield for special issues; it was predicted that this change would eventually earn the trust funds an additional $160 million per year. Thus there is a long tradition of letting the break fall to social security and not against it, as has been the recent case.

PERHAPS THE MOST APPEALING FEATURE OF THE BILL IS THE PLEASANT SIMPLICITY IT BRINGS TO THE NOW-BIZARRE INVESTMENT PRACTICES. THE TRUST FUND INVESTMENTS WOULD BECOME COMPREHENSIBLE TO THE PUBLIC — AN IMPORTANT STEP TOWARDS BUILDING PUBLIC CONFIDENCE. or I should say rebuilding public confidence. WITHOUT THE CURRENT SYSTEM OF ISSUES, MATURITIES, AND REDEMPTIONS, THE SYSTEM WOULD BE MORE MANAGEABLE AND LESS EXPENSIVE TO ADMINISTER.

FRANKLY, IT IS DIFFICULT TO DETERMINE TO WHAT EXTENT THE TRUST FUNDS ARE BEING TREATED UNFAIRLY OVER THE LONG-RUN, BUT "LONG-RUN" IS ITSELF A TRICKY CONCEPT. DEPENDING UPON THE TIME PERIOD ONE CHOOSES, RESULTS CAN APPEAR VERY DIFFERENT. indeed, WHAT IS CLEAR IS THAT THE TRUST FUNDS DO SUFFER DURING PERIODS OF RISING INTEREST RATES, BECAUSE THE EXISTING SYSTEM OF INVESTING TRUST FUND ASSETS IS NOT DESIGNED FOR PERIODS OF FLUCTUATING INTEREST RATES OR FOR PERIODS IN WHICH SPECIAL ISSUES ARE REGULARLY REQUIRED TO BE REDEEMED EARLY.

STILL CLEARER AND MORE IMPORTANT IS THE EFFECT THE CURRENT SYSTEM HAS ON PUBLIC PERCEPTION. UNLESS OUR ECONOMY SOON RETURNS TO A PERIOD OF VERY STABLE INTEREST RATES [redacted] — WHICH SEEMS HIGHLY UNLIKELY — THE EARNINGS OF THE TRUST FUNDS WILL CONTINUE TO BE A CONCERN TO THE PUBLIC. IT IS IMPERATIVE THAT WE DESIGN A SYSTEM OF INVESTMENT THAT INSURES THAT THE TRUST FUNDS ALWAYS EARN A YIELD THAT IS UP-TO-DATE. PUBLIC CONFIDENCE IN THE SYSTEM IS IMPORTANT, NOT JUST FOR TODAY, BUT FOR YEARS TO COME.

WE CANNOT AFFORD TO HAVE THE SOCIAL SECURITY TRUST FUNDS EARN SHOCKINGLY LOW YIELDS. WE CAN INSURE A FAIR YIELD THAT IS UP-TO-DATE WITHOUT ASKING THE TREASURY TO PROVIDE A SUBSIDY TO THE TRUST FUNDS. IT IS TIME TO ADAPT TO THE ECONOMIC REALITIES OF VOLATILE INTEREST RATES AND REFORM THE INVESTMENT PRACTICES OF THE SOCIAL SECURITY TRUST FUNDS. ②

Senator **Armstrong**. Thank you, gentlemen.

I just want to pin down one thing, and then I will yield to my colleagues. Just as a matter of making the record, it is my understanding that the current investment practices, those which are being used by the trustees at the present time, are in fact identical or essentially identical with those that have been in effect for a number of years, at least 15 years or so.

Representative **Shamansky**. That is my understanding.

Senator **Armstrong**. So that whatever we are talking about really is not a question of how the trust funds are presently being managed, but whether or not there should be a permanent long-term policy change.

Mr. **Proxmire**. It is my understanding that is true, since the late fifties.

Senator **Armstrong**. Senator Dole.

Senator **Dole**. Mr. Chairman, I would ask permission that a statement I have prepared be made part of the record.

[The prepared statement of Senator Dole follows:]

June 8, 1982

STATEMENT OF SENATOR DOLE
HEARING ON SOCIAL SECURITY TRUST FUND
INVESTMENT POLICY

I'd like to thank Bill Armstrong for scheduling this hearing today and assembling such an impressive list of witnesses. We will hear a wide variety of views about the management and investment of the social security trust funds, and proposals to alter current practice. This is important. The social security trust funds are critically depleted, but they nevertheless hold assets in excess of $40 billion. Interest income amounts to $3 to $4 billion a year. So much of our time has been devoted to studying the bigger issue of social security financing and how to rebuild reserves, that the issue of the return on social security investments has escaped real scrutiny.

While criticism of current practice is now surfacing, it is important to note that the guidelines for social security trust fund investments are prescribed by law--laws that date back to 1960. The Secretary of Treasury, as Managing Trustee, must invest exclusively in U.S. Government obligations traded in the open market or in special issues to the trust funds not available to the general public. These special issues earn interest according to a formula fixed in the law; their maturities are set by the Secretary. To date, Treasury has invested predominately in special issues due to a requirement that obligations traded in the open market only be purchased when "in the public interest." In the OASI trust fund, for example, about 90% of the assets are invested in special issues, which earn interest at a rate of 8 1/4 to 13 5/8%, depending on when the securities were purchased.

By and large, the various Secretaries of Treasury have followed fairly mechanical procedures for investing excess reserves, rather than operating as investment portfolio managers. Much can be said for this approach. It is likely that Treasury would be under even more fire if each Administration had aggressively pursued its own investment strategy.

According to the 1982 Board of Trustees Report, the OASDI funds earned $2.3 billion in interest income during FY 1981 -- a 9.2 percent effective annual yield on investments. The Hospital Insurance and Supplementary Medical Insurance funds earned $1.7

billion, representing an 8.9 percent return on HI investments and an 8.7 percent yield on SMI investments. The interest rate on new special issues stood at 13 1/4% last month.

In comparing the return on social security investments relative to, say, the return being earned on private portfolios, the nature of the special issues in which social security reserves are invested must be considered. Unlike ordinary government bonds or private securities that are purchased by the general public, special issues are redeemable at par--at any time--even with years left until maturity. The trust funds are thus protected from the capital losses that would generally result when interest rates are rising. This feature minimizes investment risk to the trust funds in a period when interest rates show great volatility, as they do now. This will be increasingly important in the coming months as reserve depeletion forces the rapid redemption of trust fund assets. Obviously, we will want to proceed with caution in considering modifications of investment policies which could remove these protections from capital losses.

Social security is in grave financial condition. Few would dispute that statement. Unfortunately, the magnitude of the financing problem is such that even radical changes in investment policy would be insufficient to noticeably delay the day of reckoning. According to the Social Security Board of Trustees, anywhere from $160 to $460 billion could be required to keep the system solvent over the course of the next decade. On the other hand, changes in current practice could well expose the trust funds to unforseen risk and a loss of interest income. With critically low reserves, the system will require a steady, safe investment policy that provides a fair rate of return and reasonable protection against capital losses.

I welcome the advice and recommendations of our expert witnesses. They have given a great deal of thought to these questions. The recommendations that surface today will be valuable to the Finance Committee as well as the National Commission on Social Security Reform. In fact, the Commission may wish to devote part of its discussions this year to a consideration of this issue.

I look forward to today's testimony.

Senator Dole. I certainly want to commend the chairman for scheduling this hearing, and also those of you who will be testifying. I particularly want to note that it was Senator Stennis and Senator Proxmire who several months ago urged that we do just this. We are pleased to have been able to accommodate them. We also appreciate very much Congressman Shamansky's interest.

I would just like to make one very brief comment. I think we all have the same goal in mind, and that is to see if we can improve the way the trust funds are now invested, which is the way it has been done since 1960. If action is not taken by the committee, it is certainly a matter that should be considered by the National Commission on Social Security Reform. I am a member of that commission, along with the Senator from Colorado and the Senator from New York. We will also want to discuss this matter further when we hear from the executive director of the commission, Mr. Robert Myers, and perhaps he will take note of our interest in this. Perhaps he already has. He has nodded his head. So, we are pleased to have that interest expressed from the front row.

There is one point that should be made at the start. In comparing the return on social security investments relative to, say, the return being earned on private portfolios, the nature of the special issues in which social security reserves are invested must be considered. Unlike ordinary Government bonds or private securities which are purchased by the general public, special issues are redeemable at par at any time, even with years left until maturity. The trust funds are thus protected from the capital losses that would generally result when interest rates are rising.

This feature minimizes investment risk to the trust funds in a period when interest rates show great volatility, as they do now. This will be increasingly important in the coming months, as reserve depletion forces with rapid redemption of trust fund assets. Obviously, we will want to proceed with caution in considering modifications of investment policies which could remove these protections from capital losses.

As has been pointed out by the Senator from Mississippi, we all agree now that social security is in real trouble. We may be able to postpone it for a while, but the system is in real trouble. According to the Social Security board of trustees, anywhere from $160 to $460 billion could be required to keep the system solvent over the course of the next decade. On the other hand, changes in current practice could well expose the trust funds to unforeseen risk and loss of interest income.

So, I just suggest that this is certainly a worthwhile hearing, and I commend those who are willing to participate and those who have come to testify. We will look at the problem carefully in committee, and will also discuss it in the Commission. If we can find a better way to invest the funds, I would hope the Commission would make such a recommendation, to do what the witnesses suggested. What was the figure you used, Senator Stennis? $18 billion is a lot of money. That is more than cost overruns in some of the weapons systems.

I will conclude by verifying what Senator Stennis said with reference to the lack of confidence in the system. In a poll taken not too many months ago—taken by ABC and the Washington Post in January—it was found that 66 percent of the respondents under 45 believed social security will not be there when they are eligible for benefits. Among those 18 to 30, 74 percent were skeptical.

So, obviously, we have got some credibility problems with the system. The very thing we are addressing here today is probably one of the reasons for lack of confidence. I have been asked the question—I am certain every other Senator, anybody in public office, anybody in Congress—how do you invest the funds, and why don't you receive more on your investment?

Do I understand, Senator Proxmire, that you now have made some modifications in your original proposal?

Senator **Proxmire**. Yes; I have indeed. I wouldn't change the management of the funds. I would make the investment system automatic. The reserves would be put in a savings account, maintained by the Treasury. The account would pay interest equal to the current average rate on all Treasury securities. The funds in the account could be withdrawn at any time without penalty.

Senator **Dole**. That is essentially what yours does.

Representative **Shamansky**. Essentially the same idea. I tried to stay as close to the precedent that we already have, and so mine is changing it to a savings account but having a two-tier system. I think the minute you say you are buying securities with fixed rates and times, then you raise the whole issue of capital expenditures and below par, and I don't think that is appropriate here.

Senator **Proxmire**. I would differ slightly from the distinguished Congressman. I think he makes an excellent case. I think we agree on almost everything, but I would not have a situation where the social security fund would either get a break or suffer a loss. They would get exactly the same return as everybody else got. As I understand the Congressman's proposal, it would be the higher rate of return of either long term or the shorter term.

Representative **Shamansky**. I hope you understand if that is the only point of disagreement we have, we don't have any disagreement. I am just trying to be more cautious in the changes recommended. The basic concept has to be changed from buying a fixed maturity and so on and so forth to a savings account, which is essentially what the Senator and I are talking about.

Senator **Dole**. Senator Stennis, is your proposal pretty much like the other two proposals?

Senator **Stennis**. It is somewhat different. I am willing to give authority and discretion to the managing trustee. The net result, though, is that the money must go for the benefit of the trust funds, and should be handled in the simplest possible way.

Senator **Dole**. Do I understand correctly? I think one of your last statements was that there has been a loss of interest income over the last several years but it has resulted not from mismanagement but because of the law and you believe that should be paid into the fund?

Senator **Stennis**. I do. I think there should be a restoration. In ordinary equity that is what would normally occur. That is not imputing wrongdoing to any official. It is just a condition I think that ought to be corrected.

And if I may add right here, something must be done, Senator. If you could recommend a bill that would cover this point alone before there is a Commission report or anything else, as I see it, we would not have to wait for their recommendations. We should just get back on the track here and give this fund the benefit of what it should have earned, recognizing that it is a trust fund, that it belongs to the people who paid it in, and that it does not belong to the general fund of the Treasury. That itself would be a long step forward in restoring confidence and preparing the way to make some adjustments that I think are necessary.

Representative SHAMANSKY. If I may comment, in our legal tradition, I think it is impossible to have the Secretary of the Treasury in a conflict of interest position. He wants to keep down the cost of borrowing to the Treasury, and at the same time he is a trustee of this fund, and this is a conflict of interest. We have no business placing him in that kind of impossible position, which is the basis of what the Senator is saying. They owe back the fund something. I didn't quite go that far, but I think it is an impossible position in which to place the Secretary of the Treasury. He is serving two different masters who have conflicting needs.

Senator DOLE. But you are saying, in effect, that if he minimizes the return on the trust funds, he then reduces the interest on the national debt.

Representative SHAMANSKY. Absolutely, and he shouldn't be put in that position.

Senator DOLE. But if I understand it correctly, the interest income to the trust funds does not add to the unified budget deficit. It simpy represents a transfer from the general fund to the trust funds.

Representative SHAMANSKY. But for those people who have paid that in, we do look upon that as paid into a trust fund. Those words mean something, and the faith that people have, the confidence they have in that. The person who manages it, however, should not have a conflicting need.

Senator DOLE. I do not quarrel with what you say. I just think we need to be certain where we are headed. We have that responsibility. It is now June and we hope to make the report to the Commission in November, probably a couple of weeks after the first Tuesday in November, and maybe take action yet this year. I am not certain whether the Senator from Mississippi has a quicker resolution in mind or not.

Do you think we should move without waiting for the Commission's full recommendation?

Senator STENNIS. I do, I do. I think it would be the beginning, the beginning of a foundation for a settlement of this matter, and would instill confidence that it is the people's money.

Senator DOLE. I have no other questions. I do believe that this is a constructive approach, and one thing that we must consider—and I must say for both Senators, they have been willing to address the difficult problems we face right now, not just this one but others we face in social security, and it is going to take some difficult judgments on the Senate floor I assume very soon.

Senator ARMSTRONG. Let the record of the committee reflect that at least one Senator and some staffers turned pale at the suggestion of Senator Dole that there might be a postelection session.

Senator DOLE. Which Senator?

Senator ARMSTRONG. At least one.

Senator MOYNIHAN. Mr. Chairman, I have a statement I would like to put in the record as if read.

[The prepared statement of Senator Moynihan follows:]

PREPARED STATEMENT OF SENATOR PATRICK MOYNIHAN

I would like to welcome our distinguished witnesses to this hearing on Social Security investment practices. I have for some time been disturbed by statements that the Social Security trustees were statutorily hampered from realizing an interest yield on the Social Security portfolio comparable to that available to private investors. We must consider these claims seriously, and, if they prove true, refashion the law so that Social Security investments can benefit from favorable rates of interest.

Our duty is twofold. We must ensure that the law permits the Trustees to maximize interest yields on the safest possible investments. That is elemental, and, I hardly need add, it is our paramount obligation. Beyond that, we must ensure that the Trustees can and do take full advantage of that power. The Secretary of the Treasury is both Managing Trustee of Social Security, charged with investing Social Security funds at the most favorable rate of interest paid to government securities and manager of the general Treasury, charged with increasing the funds in that Treasury. I do not suggest that the Secretary intends to deny or has denied high rates of interest to Social Security investments in an effort to hold down interest payments from the Treasury to Social Security. The problem, if there is one, is institutional. Should there be a conflict of interest in vesting one officer which both jobs then it is incumbent upon us to reduce the possibility for conflict or altogether to change the way investments are handled.

I am confident that everyone concerned is sensitive to both points, and wishes only to ensure that the handling of Social Security's investments is entirely proper, even wise. I am certain that the most prudent policy will suggest itself during today's hearing, and I thank our witnesses for giving us their time.

Senator MOYNIHAN. I thank our panelists for the presentations. We particularly appreciate our colleague, Mr. Shamansky's point that there may be a conflict of interest here that no one intended, but it is simply there.

Would I be correct to think that the Secretary of the Treasury now has the power to redeem without penalty any security which has been issued at a rate lower than currently available? He could this afternoon redeem all the bonds and notes that he has that are below the current rate and then repurchase them at the current rate. He could do that, but if he did that, he would be in a certain conflict with his other interests.

Representative SHAMANSKY. It is an impossible position.

Senator MOYNIHAN. They do experiments with white mice in laboratories that show that after a while they turn catatonic that way. I do not think Secretary Regan is going to turn catatonic over this problem. He could resolve it on his own, but he would have some conflict in doing it.

Perhaps he needs some legislative direction. I think we have very positive proposals here, and I thank the gentlemen very much, Mr. Chairman.

Senator ARMSTRONG. Senator Proxmire, I want to ask a question which may also go to the bill introduced by Mr. Shamansky.

When you describe the current market rate as the rate which you believe ought to be earned by the trust funds, are you suggesting that that be computed as a daily average, or are you saying that the funds would draw, that is, the deposits would draw whatever interest was current on the day the deposit was made until the day it was withdrawn? In other words, are you suggesting that the rate be fixed at the time of deposit, or that it simply fluctuate every day?

Senator **Proxmire**. Well, I have it three places in my bill, and it would be monthly. Let me just read, because it is a very short section.

> Monies deposited in the account shall earn interest payable monthly to the amount equal to the product obtained by multiplying the average balance of monies in the account each month by the average yield expressed as a percentage of all actively traded marketable obligations of the United States held by private investors during the month.

So you make the change once a month.

Senator **Armstrong**. So in a time of—and perhaps before I ask a further question I should inquire of Mr. Shamansky, is it the same general principle that he seeks to follow, a monthly adjustment or something like that?

I was just asking.

Representative **Shamansky**. Mine is quarterly, but with the computers you could theoretically do it daily, and the Senator does it monthly. I am doing it quarterly. As I say, I think that is a matter of just reasonable accommodation.

Senator **Armstrong**. But it is your thought in either case, each of you, that it should fluctuate on a relatively current basis rather than being fixed for a period of time related to how long the deposit is made.

Representative **Shamansky**. Yes.

Senator **Armstrong**. The reason I raise that question is this. In a time of falling interest rates, of course, that kind of current adjustment would work to the disadvantage of the trust fund, just as during a period of rising interest rates it would work to the advantage.

Senator **Proxmire**. It would, indeed, and that is exactly why we have to have our eyes wide open. If the interest rates had been falling over the last 20 years, then the trust fund would be way ahead of the private investor. My argument is that we just should not subsidize the trust fund this way out of general revenues. That is a different kind of policy decision, whether we do it or not. We certainly should not do it inadvertently by the way we modify the investment management.

Representative **Shamansky**. We should not gamble with it as you do when you buy bonds on speculation. In other words, once you go to the idea of a savings account concept, it is what it is currently earning, at least it is fair for that time. If you want to subsidize it some other way, then you do that explicitly as Senator Proxmire suggests.

Senator **Armstrong**. Is it your thought that the current market yield will be for all outstanding securities in the month or in the quarter in question, in other words, not just those that are being issued during the current month, but those which may have been previously issued and outstanding?

Representative **Shamansky**. That is my concept.

Senator **Armstrong**. In other words, the average of all of the trillion dollars of outstanding national debt.

Senator **Proxmire**. That is certainly my position, all held by private investors except, I should say, for the obligations trading at a substantial discount.

Senator **Armstrong**. How do you distinguish those? You have come exactly to the point I wanted to get at, as the yield from the Treasury's point of view is one number whereas the actual market yield is something different, and of course, some of those long-term Treasury bonds are trading very substantially.

Senator **Proxmire**. Well, here I would provide some discretion for the Secretary of the Treasury to determine what those were, to identify them and so forth. I think that is the only way that you can do it.

I realize the Secretary of the Treasury has a theoretical conflict of interest, but his discretion in this limited area could only have a relatively modest effect on the yield earned by the funds—certainly not more than a couple of basis points either way. I think we could leave it to his discretion.

Senator **Armstrong**. Mr. Stennis, I have not directed the questions to you because your bill proceeds from a slightly different idea than that of Mr. Proxmire and Mr. Shamansky, and that is that your bill gives the Secretary of the Treasury more of a fiduciary duty, and that is that he should manage it to maximize the yield, consistent with safety, or some words to that effect.

Now, if you would care to comment on this issue, I would be glad to have your thoughts on that. I am personally somewhat troubled by the discretionary aspect of this for two reasons, first for the reason that Mr. Shamansky has mentioned, that there is at least in some sense a conflict of interest, and second, because I could see that this could quickly become a political football if in fact the Secretary of the Treasury or the trustees manage the trust fund in a way which by happenstance or good luck or skill turned out to be a bit better than the market, the temptation to brag about that would be almost irresistable in an election year, and even if they did only very fractionally better, the dollars involved would be just gigantic. A tiny change in the percentage yield would be an enormous number of dollars. By the same token, if they didn't do quite so good, I would be concerned that that also could be a political issue of some sensitivity. And I don't know quite how to reconcile all these different points of views.

I have found that each of the witnesses that has spoken, I have agreed with each of them, and yet the bottom line is how do we do all of these things.

Senator **Stennis**. It is beyond me to pick out the best course from all of the choices. I do not object to leaving it with the Secretary of the Treasury if you define his duties rather strictly and specifically. He is in the business of managing money, and it seems to me like we could spell out his duties in the bill. If necessary we could go elsewhere to get the advice of private individuals, but someone has got to make the decisions. Congress can define the requirements, the limits, the boundary lines and so forth, and let it go at that. That is the problem as I see it.

Senator **Armstrong**. Well, it appears to me that we have some thinking to do on this subject.

Unless Senator Moynihan has further observations——

Senator MOYNIHAN. Just one. I want to correct myself, Mr. Chairman. I should have made clear that it is in the power of the Secretary to redeem without penalty securities held refers to the special issues, not to marketable securities. But I think it might also be useful to note that the power to redeem special issue bonds without penalty was granted to avoid any penalty to the system that came about through falling interest rates. We now have the highest real interest rates in our economic history, and it is very much the policy of this administration, as it ought to be, to bring those rates down. It would be ironic if we were to change our rules which protect the funds against falling interest rates at just the moment interest rates begin to fall. That is clearly not the purpose of either my friend Senator Proxmire or Senator Stennis or Mr. Shamansky, but I would agree that we would have to keep that in mind.

Senator PROXMIRE. I would keep that in mind, but it nevertheless seems to me there is no way that you could argue that we should take a policy decision on the fund that would either benefit or adversely affect the social security fund. In other words, what I am saying is that if you simply give them the average rate of return that every other investor in this country receives, I do not see how you can be any more equitable or fair than that. That is what the American people expect.

There are some people who would argue that we should subsidize the fund out of the general revenues. Some say we should not. But the position that I take is that we should be completely neutral as far as this is concerned and make sure the fund gets as much as other investors get, no more, no less.

Representative SHAMANSKY. If it is treated fairly going up, it should be treated fairly going down.

Senator MOYNIHAN. That would be a change in policy.

Representative SHAMANSKY. Only because we have been treating it badly as the rates were going up. I just do not see how you can then say we are going to add extra money to it that it is not otherwise entitled to. You are changing the concept from a fixed maturity, like a bond, to a savings account.

Senator MOYNIHAN. That is clear, and you have really raised some of the ethical as well as institutional concerns.

Thank you.

Senator ARMSTRONG. Colleagues, we are indebted to you for your testimony and also for the material which you put into the record.

We are delighted to have you with us, and if any or all of you would care to join us at the committee table as we hear from the other witnesses, we will be happy to have you do so.

Senator STENNIS. Thank you very much.

Senator ARMSTRONG. Members of the committee, our next panel is Mr. Harry C. Ballantyne, Chief Actuary, Social Security Administration from Baltimore, and Mr. Mark E. Stalnecker, Deputy Assistant Secretary of Federal Finance, Treasury.

Gentlemen, we are looking forward to hearing from you, and Mr. Ballantyne, why do you not proceed?

STATEMENT OF HARRY C. BALLANTYNE, CHIEF ACTUARY, SOCIAL SECURITY ADMINISTRATION, BALTIMORE, MD.

Mr. BALLANTYNE. Thank you, Mr. Chairman. I am pleased to be here.

I would like to summarize my statement and request that the full statement and the attachments be put into the record.

Senator ARMSTRONG. We will be happy to have the entire statement in the record, and we are grateful to you for summarizing it for us.

Mr. BALLANTYNE. Thank you, Mr. Chairman.

This will be a brief summary because some of the things have already been discussed.

I appreciate the opportunity to appear before you today to discuss the current policies governing investment of the four social security trust funds. As you are already aware, any social security tax revenues and other income not needed to pay current benefits or administrative expenses are invested at the time of receipt in U.S. Government obligations. Interest income to the trust funds in fiscal year 1981 amounted to $4 billion. Although this represented only 2.2 percent of total income, the proper management of trust fund assets is of vital importance.

Since 1960 it has been the policy of the Secretary of the Treasury, as Managing Trustee, to invest trust fund receipts almost exclusively in special obligations of the U.S. Government issued only for purchase by the trust funds. The law specifies that the maturity dates on special obligations be fixed with due regard to the needs of the trust funds. Under long established policy and practice, the maturity dates for the holdings of special issues have been spread as nearly as practicable in equal amounts over a 15-year period. By law, the special obligations are issued bearing an interest rate equal to the average market yield on all interest bearing marketable obligations of the United States not due or callable for more than 4 years.

Over the years, such long-term obligations have usually had a higher rate of return than short-term obligations. Therefore, the market yield formula, based on long-term securities, was generally beneficial to the trust funds as well as reflective of the long-term nature of the programs obligations.

The effective annual rate of interest earned by the combined assets of the OASI and DI trust funds during the 12-month period ending June 30, 1981, was 9.2 percent. Interest rates on recently purchased special issues were considerably higher, 13 percent in June 1981 and 15¼ percent in October 1981.

The 9.2-percent rate of return on OASI and DI assets was lower than the yields obtained recently by money market funds invested exclusively in Government securities. However, the investment portfolios of these money market funds are concentrated in very recent issues, while the trust funds are invested in securities purchased over a long period of years. A more appropriate comparison would be with the average rate of return earned by a prudent, well-established private investment organization on its total portfolio. The average rate of investment earnings for all U.S. life insurance companies, for example, compares closely with the rate of return on the trust funds' investments. The net rate of investment income for all U.S. life insurance companies in calendar year 1980, was 8 percent. The preliminary estimate for 1981 is 8.4 percent. The combined OASI and DI trust funds, in comparison, experienced an effective rate of return of 8.4 percent and 9.2 percent during the 12-month periods ending June 30, 1980 and June 30, 1981, respectively.

Recently, yield rates on short-term U.S. Government obligations have been higher than yield rates on long-term obligations, making the purchase of short-term obligations appear to be an attractive alternative to the present investment policy. However, this recent pattern is an inversion of the typical relationship between short- and long-term rates which cannot be expected to persist. Were we to change to a short-term investment strategy now, the trust funds would be disadvantaged in the years ahead when interest rates decline, and we would have forgone the opportunity to lock in on today's higher rates for long-term investments.

Over time, the effect on the trust funds of changes in the long- and short-term interest rates should balance out. While the average interest rate the trust funds have been receiving in the recent period of rising interest rates is lower than that for new marketable obligations, this difference should be offset when interest rates fall and the trust funds continue to benefit from long-term investments made at higher rates of interest.

It seems prudent to follow a consistent length of maturity basis for trust fund investments over the years rather than to speculate from time to time as to whether to be in short-term, medium-term or long-term obligations.

Furthermore, it should be kept in mind that any investment strategy which is very advantageous to the Social Security trust funds is equally disadvantageous to the general fund.

On balance, I think it is fair to conclude that the present policies and procedures governing investment of the trust funds are equitable both to the trust funds themselves and to the general fund of the Treasury. Although the present trust fund investment procedures may not maximize interest income during a reversal of the historic relationshp of long- and short-term interest rates, the investment procedures do produce a beneficial rate of return at other times. We believe that a steady, consistent approach to trust fund investments provides stability and is best for the Social Security system over the long run. Thank you, Mr. Chairman.

[The prepared statement of Harry C. Ballantyne follows:]

PREPARED STATEMENT OF HARRY C. BALLANTYNE

MR. CHAIRMAN AND MEMBERS OF THE SUBCOMMITTEE

I appreciate the opportunity to appear before you today to discuss the continued appropriateness of current policies governing investment of the four Social Security trust funds--the Old-Age and Survivors Insurance (OASI) Trust Fund, the Disability Insurance (DI) Trust Fund, the Hospital Insurance (HI) Trust Fund, and the Supplementary Medical Insurance (SMI) Trust Fund. As you are aware, any Social Security tax revenues and other income which are not needed to pay current benefit costs or administrative expenses are held in the trust funds and are invested at the time of receipt in U.S. Government obligations. Interest income to the funds in fiscal year 1981 amounted to $4.0 billion. Although this represented only 2.2 percent of total income to the funds, the proper management of trust fund assets is of vital importance.

Investment Procedures

Special Issues

Since 1960, the law has provided that trust fund investments shall be in special obligations of the U.S. Government issued exclusively for purchase by the trust funds except when the Secretary of the Treasury, as Managing Trustee, determines that it is in the public interest to invest in publicly available obligations of the Federal Government or in the obligations of certain Federal agencies. (The 1960 change in the law favoring special issues made the statute consistent with Treasury's actual practice of investing almost all of the funds in special issues.) It has been the policy of every Managing Trustee since then to invest almost exclusively in special obligations in order to avoid disturbing the capital market, unless there has been some overriding reason of national policy for buying marketable Treasury securities.

This practice protects the Federal credit market from sudden distortion in prices that could result from the purchase of securities worth about $12 billion (and the sale of a like amount) each month for OASDI alone as new tax receipts are invested and as securities are redeemed in order to pay benefits. Also, investing almost exclusively in special issues allows the trust funds to cash in obligations at par value at any time funds are needed, whereas marketable obligations would have to be sold on the open market (at considerably below par in times of rising interest rates) if not held to maturity. As the trust fund balances have declined in recent years, premature redemption of securities has become more commonplace, so that open-market purchases could involve particular risk.

Over the years, Treasury has determined the purchase of marketable securities to be in the public interest only when such a purchase might serve to stabilize the market for Treasury issues and when the yields on marketable securities are higher than the yield on new special issues. Treasury has maintained that since a market that needs stabilizing is one in which bond prices are falling and interest rates rising, the conditions under which purchase of public obligations is deemed essential to the national interest are the same conditions under which the narrower interests of the trust funds are promoted by "better buys." In practice, as I have noted, the purchase of marketable securities has been rare. In recent years, the Managing Trustee has accepted only newly issued marketable bonds in exchange for a previously purchased marketable issue that had reached maturity. The last exchange of this nature was completed in FY 1980. Today, about 90 percent of the investments of the Old-Age and Survivors Insurance Trust Fund are in special obligations. (See Attachment A).

Long-Term Obligations

The trust funds are invested primarily in long-term obligations. This investment policy was reviewed and approved in 1959 by a congressionally-mandated Advisory Council on Social Security Financing. The Council stated that long-term investments by the trust funds are appropriate due to the long-term character of the funds and of the Social Security program's benefit obligations. The law has never specified the maturity dates to be set for trust fund investments; the only requirement is that the maturities on special obligations be "fixed with due regard to the needs of the trust funds." Under long established policy and practice, the maturity dates for the holdings of special issues have been spread as nearly as practicable in equal amounts over a 15-year period.

Market-Yield Formula

By law, the special obligations issued exclusively to the trust funds bear interest equal to the average market yield on all interest-bearing marketable obligations of the United States not due or callable for more than 4 years. This market-yield formula was enacted in 1960 after it had been recommended by the 1959 Advisory Council.

The 1959 Council reasoned that a market-yield formula would produce a rate of interest that, in principle, would equal the rate of return being realized by investors who hold long-term Government securities in the open market at the time the special obligation is issued. The Council thought that such a rate of return would provide neither a financial advantage nor a disadvantage to the funds, and would go a long way toward eliminating any appearance of conflict of interest that might be encountered by the Secretary of the Treasury, acting both as the principal fiscal officer of the Government and as manager of the trust funds, in deciding whether to invest trust fund assets in marketable obligations or in special issues.

In 1960, and as has generally been true historically, long-term Federal obligations had a higher rate of return than short-term obligations. Therefore, the market-yield formula (based on long-term securities) was beneficial to the trust funds as well as reflective of the long-term nature of the program's obligations.

Current Holdings of the Trust Funds

At the end of FY 1981, the assets of the four trust funds totalled about $43.6 billion. The effective annual rate of interest earned by the combined assets of the OASI and DI trust funds during the 12-month period ending June 30, 1981 was 9.2 percent. The HI trust fund's assets earned 8.9 percent during that period, and the SMI trust fund's assets earned 8.7 percent. Interest rates on recently purchased special issues were considerably higher--13 percent in June 1981 and 15½ percent in October 1981. (Attachment B indicates the effective rates of return for trust fund investments from 1961 through 1981.)

Criticisms of Investment Results

Recently, there has been substantial criticism of trust fund investment practice. It has been suggested that the trust funds may have received less than a reasonable return on their assets over the years--particularly over the last few years when interest rates on short-term open-market obligations have risen dramatically. For example, it has been pointed out that, during the 12-month period ending June 30, 1980, the effective annual rate of interest earned by the combined OASI and DI Trust Funds was only 8.4 percent, whereas private money managers who invest exclusively in government securities achieved a 13.5 percent yield over the same period.

The higher yields obtained recently by these money market funds primarily reflects the difference in the age of holdings in the trust fund portfolios compared with those of money market funds. The trust fund portfolios contain securities purchased over a long period of years, while money market portfolios are concentrated in very recent issues. A more appropriate comparison, however, is between the return on trust fund investments and the average rate of return earned by a prudent, well-established private investment organization on its total portfolio. The average rate of investment earnings for all United States life insurance companies, for example, compares closely with the rate of return on the trust funds' investments. The net rate of investment income (before Federal income taxes) for all U.S. life insurance companies in calendar year 1980 was

8.0 percent, according to the American Council of Life Insurance. The preliminary estimate of the corresponding figure for calendar year 1981 is 8.4 percent. In comparison, the combined OASI and DI Trust Funds experienced an investment rate of return of 8.4 percent and 9.2 percent during the 12-month periods ending June 30, 1980 and June 30, 1981, respectively.

It is also significant to note that current Social Security trust fund investments compared favorably with private experience. For example, the interest rate on special issues acquired in June 1981 was 13 percent, and it was at this rate that some $20 billion of new issues were acquired last June 30, with maturities of up to 15 years. (Attachment C shows the average market yield rate on marketable interest-bearing obligations of the U.S. Government over the last 15 years.) Also, of course, as old securities mature, and as new higher-interest securities are purchased, the average effective rate of return on the assets of the trust funds will rise, as demonstrated by the increase in the rate from 8.4 percent for the year ended June 30, 1980 to 9.2 percent for the year ended June 30, 1981.

Since, as I mentioned earlier, all special issues must be purchased by the trust funds at the long-term rate, purchase of short-term obligations appears to be an attractive alternative when short-term rates are higher than long-term rates. However, the recent pattern is an inversion of the typical relationship between short- and long-term rates which cannot be expected to persist. Moreover, were we to change to a short-term investment strategy now, the trust funds would be disadvantaged in the years ahead when interest rates decline, and we would have forgone the opportunity to "lock-in" on today's higher rates for long-term investments.

Over time, the effect on the trust funds of changes in the long- and short-term interest rates should balance out. While the average interest rate the trust funds are receiving in this period of rising interest rates is lower than that for new marketable obligations, this difference should be offset when interest rates fall and the trust funds continue to benefit from long-term investments made at higher rates of interest. In addition, it seems prudent to follow a consistent length-of-maturity basis for trust fund investments over the years, rather than to "speculate" from time to time as to whether to be in short-term, medium-term, or long-term obligations.

Finally, it has been suggested that trust fund securities that have lower than current yields should be redeemed each year for securities that have higher yields. While this investment procedure would increase interest income to the trust funds, it should be kept in mind that the added interest income would have to be paid from the general fund of the Treasury so that any investment strategy which is very advantageous to Social Security is equally disadvantageous to the general fund. While the Social Security trust funds might fare better under a variety of options, the additional interest earnings to the funds would ultimately be reflected in higher Federal income taxes or a larger public debt. This, of course, can be viewed as an indirect form of general-revenue financing for Social Security.

Summary

On balance, I think it is fair to conclude that the present policies and procedures governing investment of the trust funds are equitable both to the funds themselves and to the general fund of the Treasury. ~~The rates of return received on trust fund investments are reasonable when viewed in the context of the nature of the portfolio held by the funds.~~

Although the present trust fund investment procedures may not maximize interest income during a reversal of the historic relationship of short and long-term interest rates, ~~at other times~~ the investment procedures do produce a highly beneficial rate of return. at other times. We believe that a steady, consistent approach to trust fund investments provides stability and is best for the Social Security system over the long run. (†)

Attachment A

Distribution of assets of Social Security Trust Funds, by type, September 30, 1981

(In millions)

Category	OASI	DI	HI	SMI	Total
Special Issues	$20,742	$3,095	$18,141	$3,821	$45,799
Marketable Securities 1/	1,947	296	---	---	2,243
Participation Certificates	555	---	50	---	605
Undisbursed Balances	590	2	-99 2/	-79 2/	414
Total Assets	23,834	3,392	18,093	3,743	49,062

1/ U.S. Treasury securities only (participation certificates of the Government National Mortgage Association are also marketable, but are not included here).

2/ The negative figures represent an extension of credit which was covered by the redemption of securities on the first day of the following month.

Note: Totals do not necessarily equal the sum of rounded components.

Social Security Administration
Office of the Actuary
June 2, 1982

Attachment B

EFFECTIVE RATES OF RETURN FOR SOCIAL SECURITY TRUST FUNDS IN VARIOUS YEARS

12-Month Period Ending on June 30	OASI	DI	OASI-DI	HI	SMI
1961	2.7%	2.7%	2.7%	a/	a/
1962	2.8	2.9	2.8	a/	a/
1963	2.9	3.0	2.9	a/	a/
1964	3.0	3.1	3.0	a/	a/
1965	3.1	3.2	3.2	a/	a/
1966	3.3	3.6	3.3	a/	a/
1967	3.6	3.9	3.6	4.6%	4.6%
1968	3.9	4.2	3.9	4.9	4.8
1969	4.1	4.8	4.2	5.3	5.2
1970	4.7	5.6	4.8	6.0	5.9
1971	5.2	6.1	5.3	6.5	6.4
1972	5.3	6.1	5.4	6.7	6.2
1973	5.5	6.1	5.6	6.4	6.1
1974	5.9	6.4	6.1	6.7	6.8
1975	6.5	6.8	6.5	7.2	7.1
1976	6.8	6.8	6.8	7.2	7.2
1977	6.9	7.0	6.9	7.3	7.4
1978	7.2	7.4	7.2	7.4	7.4
1979	7.4	7.9	7.4	7.7	8.2
1980	8.3	8.8	8.4	8.2	8.3
1981	9.2	9.3	9.2	8.9	8.7

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a/ Trust fund began operation in 1966.

Attachment C

AVERAGE MARKET-YIELD RATE ON MARKETABLE INTEREST-BEARING OBLIGATIONS OF THE UNITED STATES, AS OF THE BEGINNING OF JUNE OF VARIOUS YEAR

Year	All Obligations	Trust-Funds Special-Issue Rate for June [1]	Difference
1981	14 7/8%	13%	1 7/8%
1980	8 7/8	9 3/4	-7/8
1979	9 1/2	8 3/4	3/4
1978	7 3/4	8 1/4	-1/2
1977	6	7 1/8	-1 1/8
1976	6 5/8	7 1/2	-7/8
1975	6 1/4	7 3/8	-1 1/8
1974	8 3/8	7 5/8	3/4
1973	6 7/8	6 5/8	1/4
1972	4 5/8	5 3/4	-7/8
1971	5 1/4	6 1/8	-7/8
1970	5 1/2	7 5/8	-2 1/8
1969	6 1/2	6 1/2	---
1968	5 3/4	5 5/8	1/8
1967	4 1/8	4 3/4	-5/8

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[1] Average market-yield rate of U.S. marketable obligations with 4 or more years until maturity.

Senator ARMSTRONG. Thank you very much, Mr. Ballantyne. We appreciate that.

I expect that both Senator Moynihan and I will have some questions for you presently.

Mr. Stalnecker.

STATEMENT OF MARK E. STALNECKER, DEPUTY ASSISTANT SECRETARY OF THE TREASURY FOR FEDERAL FINANCE

Mr. STALNECKER. Thank you.

Mr. Chairman and members of the subcommittee, I am pleased to present the views of the Treasury Department today on the subject of policies governing the investment of social security trust fund assets. My comments will be directed only at the investment policies of the trust funds and will not address the more fundamental questions of funding and benefit levels.

With your permission, I will make a summary statement and submit the full testimony for the record.

Senator ARMSTRONG. Thank you very much.

Mr. STALNECKER. Under the social security laws, amounts in the social security trust funds not needed to meet current benefit payments and administrative expenses may be invested in interest-bearing obligations of the United States or in obligations guaranteed as to both principal and interest by the United States. The laws authorize the Secretary of the Treasury to issue special nonmarketable public debt obligations to the trust funds and provide that the funds be invested in these special nonmarketable issues unless the public interest indicates otherwise. Under a 1960 amendment, these special obligations bear interest determined by a statutory formula which seeks to approximate the interest rates the Treasury would pay in the market for borrowing for a period of 4 or more years. Under the statutory interest formula, trust fund investments in special obligations made during the month of June 1982 bear interest at 13¼ percent.

Since 1960, investment policy has been to invest daily trust fund receipts in special nonmarketable Treasury obligations which mature on the upcoming June 30. On June 30, these maturing securities are redeemed and reinvested in longer term securities. The maturities of these longer term investments is determined by the projected cash need of the funds. The original intent was to maintain an approximately balanced portfolio with maturities extending as far as 15 years; that is, approximately one-fifteenth of the portfolio would mature in each of the next 15 years. The deterioration of some of the funds over the years has resulted in a departure from this balanced portfolio objective. In order to meet current benefit payments, securities maturing on the upcoming June 30 are redeemed lowest interest rate first. When the current June 30 maturities are exhausted, the policy is to redeem securities maturing on the following June 30, lowest interest rate first, and so on. As a result of this procedure, some of the trust funds now hold mainly longer term maturities.

At the outset, let me emphasize that decisions on the broader question of social security funding, that is, assuring adequate social security taxes or other sources of funds to meet future benefit payments, could affect investment policies. On the other hand, investment earnings are only a minor source of income to the funds. Thus, the funding problem obviously cannot be resolved by changes in investment policy, although these are important.

We believe that the long-range investment policies governing the social security trust funds and other trust funds should not be dictated by the happenstance of current relationships between short-term and long-term interest rates. At the time the present law governing the investment of the social security funds was enacted in 1960, long-term market rates were higher than short-term rates. For example, 3-month Treasury bills were about 2.9 percent and yields on 10-year Treasuries at that time were about 4.1 percent. Thus, the statutory requirement that the interest rate on fund investments be based on market yields on Treasury securities with 4 or more years to maturity resulted in a higher return to the funds than would have been realized from a formula based on short-term rates.

Since 1960, long-term rates have generally been higher than short-term rates, but the relationship has fluctuated substantially with changing market conditions, and in recent years there have been prolonged periods when short-term rates were higher than long-term rates. Thus, the earnings of the funds will not necessarily be maximized by requiring that future investments be tied to either short-term or long-term rates.

The investment earnings of the funds would of course be increased if the Treasury were to pay a higher interest rate on fund investments than the Treasury is required to pay on comparable maturity borrowings in the market. However, this would result in a completely arbitrary subsidy to the funds at the expense of the general taxpayer, and the subsidy thus provided would not be subject to the congressional control and scrutiny inherent in the normal appropriations process.

To assure that Treasury issues to the trust funds are at interest rates consistent with Treasury's current cost of borrowing in the market, the interest rates should be related to the maturities on the issues. That is, a 1-year issue to the trust funds would carry a rate equal to the estimated rate Treasury would pay at that time on a 1-year issue in the market, the rate on a 5-year issue would be based on Treasury's 5-year market rate and so on. As to the appropriate maturities of issues to the trust funds, we believe that the selection of maturities should be based on the expected cash needs of the funds. A statutory requirement that the funds be invested in short-term issues and rolled over as they mature would result in excessive dependence on short-term interest rates, which are generally lower than long-term rates and considerably more volatile than long-term rates.

While in hindsight a policy of rolling over trust fund assets through the issuance of short-term securities would have been beneficial to the funds over the past 20 years of rising rates, there is no way to know if this policy or any other policy of maturity selection on the basis of interest rate forecasts will maximize fund earnings over the next 20 years. Thus, the appropriate investment policy is to pick one strategy, that is, selecting maturities based on cash needs the way it currently is, and sticking to it.

Given the investment principles that I have suggested, I would now like to turn to the present specific statutory requirement for the investment of social security funds in special nonmarketable issues.

Existing law provides, and I quote here from the statute, that:

> Such obligations issued for purchase by the trust funds shall have maturities fixed with due regard for the needs of the trust funds and shall bear interest at a rate equal to the average market yield * * * on all marketable interest-bearing obligations of the United States then forming a part of the public debt which are not due or callable until after the expiration of 4 years from the end of such calendar month * * *."

There are three apparent deficiencies in this statutory formula.

First, the requirement that the interest rate be based on yields on Treasury marketable issues with 4 or more years to maturity prevents the Treasury from providing interest rates related to the specific maturities of the issues to the trust funds. Thus, when short-term rates are higher than long-term rates, as was generally the case in 1979 through 1981, the trust funds receive a lower rate of return than they would receive if the statute permitted Treasury to pay interest rates related to the yields on Treasury marketable issues of comparable maturities.

Second, the requirement that the obligations issued to the funds bear interest at a rate equal to the average market yield at the end of the month preceding the date of issue subjects the earnings of the funds to erratic fluctuations which may occur on any one day in the market, because of market reactions to short-term economic or financial developments or other unsettling news events. A better approach would be to base the interest rate on an average over a period which would provide a more equitable rate of return and would help assure more stability in the earnings of the funds.

Third, the requirement that the obligations issued to the funds bear interest rates equal to market yields on all marketable interest-bearing obligations of the United States of the prescribed maturities results in a somewhat lower rate of return to the funds than Treasury would be required to pay on new issues in the market. That is, under this statutory formula, Treasury must include in its rate computation the yields on many outstanding securities which were issued many years ago at market rates considerably below current market yields. Since such issues are thus traded at deep discounts in the current market, they are especially attractive to purchasers who benefit from the capital gains tax advantage of deep discount issues as well as to purchasers who gain special tax advantage from the so-called flower bonds which are redeemable at par for payment of estate taxes. Consequently, such issues are traded at relatively higher prices and thus lower nominal yields than would be required on Treasury new issues. This inequity to the trust funds could be remedied by permitting the Secretary of the Treasury greater discretion to base his rate determinations on current market yields on selected outstanding issues which are reasonably reflective of Treasury's current borrowing costs.

While correction of the above deficiencies in the statutory interest rate formula might not have a significant impact on the current earnings of the trust funds, there would be greater assurance of a more equitable and market-related return to the funds in the future.

This completes my prepared remarks. However, I will answer any questions the Subcommittee may have.

[The prepared statement of Mark E. Stalnecker follows:]

PREPARED STATEMENT OF MARK E. STALNECKER

Mr. Chairman and Members of the Subcommittee, I am pleased to present the views of the Treasury Department on the subject of policies governing the investment of social security trust fund assets. My comments will be directed only at the investment policies of the trust funds and will not address the more fundamental questions of funding and benefit levels.

The social security trust funds consist of four separate funds—the Old-Age and Survivors Insurance Trust Fund, the Disability Insurance Trust Fund, the Hospital Insurance Trust Fund, and the Supplementary Medical Insurance Trust Fund. The assets of the funds were $50.0 billion as of May 31, 1982. The investment of the funds is by law the responsibility of the Secretary of the Treasury.

Under the social security laws, amounts in the social security trust funds not needed to meet current benefit payments and administrative expenses may be invested in interest-bearing obligations of the United States or in obligations guaranteed as to both principal and interest by the United States. The laws authorize the Secretary of the Treasury to issue special, non-marketable public debt obligations to the trust funds and provide that the funds be invested in these special non-marketable issues unless the public interest indicates otherwise. Under a 1960 amendment, these special obligations bear interest determined by a statutory formula which seeks to approximate the interest rates the Treasury would pay in the market for borrowing for a period of four or more years. Under this statutory interest formula, trust fund investments in special obligations made during the month of June 1982 bear interest at 13¼ percent.

Since 1960, investment policy has been to invest daily trust fund receipts in special non-marketable Treasury obligations which mature on the upcoming June 30. On June 30, these maturing securities are redeemed and reinvested in longer term securities. The maturities of these longer term investments is determined by the projected cash needs of the funds. The original intent was to maintain an approximately balanced portfolio, with maturities extending as far as 15 years, i.e., approximately one-fifteenth of the portfolio would mature in each of the next 15 years. The deterioration of some of the funds over the years has resulted in a departure from this balanced portfolio objective. In order to meet current benefit payments, securities maturing on the upcoming June 30 are redeemed, lowest interest rate first. When the current June 30 maturities are exhausted, the policy is to redeem securities maturing on the following June 30, lowest interest first, and so on. As a result of this procedure, some of the trust funds now hold mainly long-term maturities.

The Treasury has made certain administrative changes in recent years in order to improve the earnings of the funds. The Treasury has given the trust funds the benefit of the interest on the float (checks outstanding but not yet cleared) on social security checks and has accelerated collection of social security contributions from State and local government employers.

The deteriorating condition of the funds and the current period of high market rates of interest have given rise to a number of suggestions for improving the investment performance of the funds. These suggestions have included proposals to modify the statutory interest rate formula to give greater weight to short-term market rates of interest when they are higher than long-term rates, to purchase Treasury and other securities in the open market, and to shorten the maturities of the special issues purchased by the funds since long-term special issues are often redeemed before maturity when trust fund outgo exceeds income.

At the outset, let me emphasize that decisions on the broader question of social security funding, that is, assuring adequate social security taxes or other sources of funds to meet future benefit payments, could affect investment policy. On the other hand, investment earnings are only a minor source of income to the funds. Thus, the funding problem obviously cannot be resolved by changes in investment policy although there are important.

We believe that the long-range investment policies governing the social security trust funds, and other trust funds, should not be dictated by the happenstance of current relationships between short-term and long-term interest rates. At the time the present law governing the investment of the social security funds was enacted, in 1960, long-term market rates were higher than short-term rates. For example, 3-month Treasury bills were about 2.9 percent, and yields on 10-year Treasuries were about 4.1 percent. Thus, the statutory requirement that the interest rate on fund investments be based on market yields on Treasury securities with four or more years to maturity resulted in a higher return to the funds than would have been realized from a formula based on short-term rates. Since 1960 long-term rates have generally been higher than short-term rates, but the relationship has fluctuated substantially with changing market conditions, and in recent years there have been prolonged periods when short-term rates were higher than long-term rates. This relationship has changed dramatically over the past year, as short-term rates declined relative to long-term rates. The 3-month bill rate is currently about 12.6 percent (coupon equivalent) and the 10-year rate is about 13.9 percent. In comparison, in May 1981 the 3-month bill rate was as high as 18.0 percent, while the 10-year rate was 14.7 percent. Thus, the earnings of the funds will not necessarily be maximized by requiring that future investments be tied to either short-term or long-term rates.

Much public criticism was focused last year on a reported 8.3 percent earning rate for the social security funds. The 8.3 percent rate was the average earning rate for the Old-Age and Survivors Insurance Trust Fund for the 12-month period ended June 30, 1980. Since that time, market rates of interest have increased substantially. As a result of two factors—investment of new receipts in securities with current higher market-related rates of interest and the retirement of older, low-rate investments—the fund was earning at an annualized rate of 10.8 percent as of September 30, 1981, and 11.3 percent as of May 31, 1982. The experience of the old-age insurance fund and the other social security funds is typical of funds invested in long-term securities in a rising interest rate environment. That is, because of the weight of investments made in the past at then prevailing lower market rates, the average rate earned by the portfolio will lag the rates obtainable on new investments. While the rates on the longer-term securities held by the funds were in line with market rates at the time the securities were issued, they are now substantially below current market rates on new Treasury issues. As I mentioned earlier, trust fund investments in special Treasury nonmarketable obligations during June bear interest at 13¼ percent.

The investment earnings of the funds would of course be increased if the Treasury were to pay a higher interest rate on fund investments than the Treasury is required to pay on comparable maturity borrowings in the market. However, this would result in a completely arbitrary subsidy to the funds at the expense of the general taxpayer, and the subsidy thus provided would not be subject to the Congressional control and scrutiny inherent in the normal appropriations process.

To assure that Treasury issues to the trust funds are at interest rates consistent with Treasury's current cost of borrowing in the market the interest rates should be related to the maturities of the issues. That is, a one-year issue to the trust funds would carry a rate equal to the estimated rate Treasury would pay at that time on a one-year issue in the market, the rate on a five-year issue would be based on Treasury's five-year market rate, and so on. As to the appropriate maturities of issues to the trust funds, we believe that the selection of maturities should be based on the expected cash needs of the funds. A statutory requirement that the funds be invested in short-term issues and rolled over as they mature would result in excessive dependence on short-term interest rates, which are generally lower than long-term rates, and considerable volatile than long-term rates. While, in hindsight, a policy of rolling over trust fund assets through the issuance of short-term securities would have been beneficial to the funds over the past twenty years of secularly rising rates, there is no way to know if this policy, or any other policy of maturity selection on the basis of interest rate forecasts will maximize fund earnings over the next twenty years. Thus, the appropriate investment policy is to pick one strategy i.e., selecting maturities based on cash needs and stick to it.

Given the investment principles I suggested, I would now like to turn to the present specific statutory requirement for the investment of the social security funds in special nonmarketable issues. Existing law provides:

"Such obligations issued for purchase by the Trust Funds shall have maturities fixed with due regard for the needs of the Trust Funds and shall bear interest at a rate equal to the average market yield on all marketable interest-bearing obligations of the United States then forming a part of the public debt which are not due or callable until after the expiration of four years from the end of such calendar month; . . ."

There are three apparent deficiencies in this statutory formula.

First, the requirement that the interest rate be based on yields on Treasury marketable issues with four or more years to maturity prevents the Treasury from providing interest rates related to the specific maturities of the issues to the trust funds. Thus, when short-term rates are higher than long-term rates, as was generally the case in 1979-1981, the trust funds receive a lower rate of return than they would receive if the statute permitted Treasury to pay interest rates related to the yields on Treasury marketable issues of comparable maturities.

Second, the requirement that the obligations issued to the funds bear interest at a rate equal to the average market yield at the end of the month preceding the date of issue subjects the earnings of the funds to erratic fluctuations which may occur on any one day in the market, because of market reactions to short-term economic or financial developments or other unsettling news events. A better approach would be to base the interest rate on an average over a period, which would provide a more equitable rate of return and would help assure more stability in the earnings of the funds.

Third, the requirement that the obligations issued to the funds bear interest rates equal to market yields on all marketable interest-bearing obligations of the United States of the prescribed maturities results in a somewhat lower rate of return to the funds than Treasury would be required to pay on new issues in the market. That is, under this statutory formula, Treasury must include in its rate computation the yields on many outstanding securities which were issued many years ago at market rates considerably below current market yields. Since such issues are thus traded at deep discounts in the current market, they are especially attractive to purchasers who benefit from the capital gains tax advantage of deep discount issues as well as to purchasers who gain special tax advantages from the so-called "flower bonds" which are redeemable at par for the payment of estate taxes. Consequently such issues are traded at relatively higher prices, and thus lower nominal yields, than would be required on Treasury new issues. This inequity to the trust funds could be remedied by permitting the Secretary of the Treasury greater discretion to base his rate determinations on current market yields on selected outstanding issues which are reasonably reflective of Treasury's current borrowing costs.

While correction of the above deficiencies in the statutory interest rate formula might not have a significant impact on the current earnings of the trust funds, there would be greater assurance of a more equitable and market-related return to the funds in the future.

This completes my prepared remarks. However, I will answer any questions the Subcommittee may have.

Senator ARMSTRONG. Thank you very much.

Senator Moynihan.

Senator MOYNIHAN. Thank you very much, Mr. Ballantyne and Mr. Stalnecker for a very precise statement of the situation. We see about what we think we have here, an issue that is significant without, in a certain sense, being substantial. Unhappily the funds are not high enough for greater returns to be formative in the future.

May I ask first of all, out of plain curiosity, what is a flower bond?

Mr. STALNECKER. A flower bond is so-called because of the foliage that grows on one's grave. The flower bonds have special estate tax privileges which allow the estate of a deceased individual to turn them into the Treasury at par in payment of the Federal estate taxes.

Senator MOYNIHAN. We issue such bonds?

Mr. STALNECKER. We do not any more. These bonds were issued years ago when interest rates were 3 or 4 percent generally. As a result, these securities, although they bear very small coupons, are traded on the market at a much higher price than they would if they did not have this estate tax privilege. In fact, their nominal yields are more in the 6-percent range rather than the 13- or 14-percent range of the normal Treasury yields. So they are called flower bonds in light of the prospective buyers.

Senator MOYNIHAN. You learn something every day on this committee.

Could I ask two things of you, Mr. Secretary? And that is, is it beyond the range or is it within the range of reasonable effort, for you to get us an estimate of what the additional return to the trust fund would be had we not had this policy of holding on to low-yielding special issues over say, the last 20 years, say 1960 or 1962?

Do you think you could give us some sense without having to swear that this is precisely the number? But what have we missed here?

Mr. STALNECKER. Are you referring to a formulation that would relate the interest rate to the actual maturity of the securities purchased, or a different investment policy altogether in terms of the maturity selections?

Senator MOYNIHAN. Could I say an investment policy that would say that at any moment that the rate for new special issue bonds rose above the rate for the bonds then in the portfolio that you would just roll them over, which you have the right to do.

Mr. STALNECKFR. Are you saying if at any point over the last 20 years the Secretary of the Treasury had redeemed all of those securities that were issued at a rate below current market rate, and then rolled them over?

Senator MOYNIHAN. Yes.

Mr. STALNECKER. I can look into that. I am not sure how easily that can be determined.

Senator MOYNIHAN. It does not sound easy, but could you give us an estimate and tell us if you cannot?

Mr. STALNECKER. I will look into it.

Senator MOYNIHAN. And second, it is true the Secretary could just roll securities over and always keep the maximum rate?

Mr. STALNECKER. I believe there is nothing in the statute that would prohibit such an activity, although I do not think that anything in the legislative history of the social security trust funds or even any financial theory would justify such an activity.

Senator MOYNIHAN. Because you have thought in terms of orderly marketing in part.

Mr. STALNECKER. Because the securities would not be traded on the marketplace, there would really not be a market disturbance. The real question is the question of subsidizing the social security trust funds at the expense of the Treasury.

Senator MOYNIHAN. This conflict of interest which is not intended to mean anything more than an institutional conflict. You referred to a subsidy. Now, the Secretary has two roles here.

Mr. STALNECKER. Basically I think it is what has been alluded to earlier today as a conflict of interest. A trustee's function in the private sector and the fiduciary role that a trustee has is different from the role of a managing trustee in the investment of a social security trust fund, because in this instance most of the duties of the managing trustee are statutory rather than fiduciary in nature. To the extent that the statute really prohibits certain activities or specifies that certain activities should be undertaken, the trustees were always satisfied.

Senator MOYNIHAN. That is a fair distinction. Two other things. I do not want to keep my colleagues. One is that you grant that there has been a subsidy to the fund. The original provision mandated that the special issue bond paid 3 percent. There has always been a subsidy from time to time, and the prospect of subsidy is something that you had to deal with, to use your words.

Mr. STALNECKER. There have been subsidies in the history of the funds.

Senator MOYNIHAN. And second, would it be possible to ask you—and this would be of particular interest to the Commission—would you send us a Treasury bill? You have three proposals in your testimony. Would you draft up what Treasury would like?

Mr. STALNECKER. We would be happy to work that up with the staff.

Senator MOYNIHAN. I thank you. I thank you, Mr. Ballantyne, and I thank you, Mr. Secretary, Mr. Chairman.

Senator ARMSTRONG. Thank you, Senator Moynihan.

Now, Senator Stennis, any observations or questions for these witnesses?

Senator STENNIS. Mr. Chairman, just this one question.

What is your basic concept of these funds? Do you look upon them as belonging to the Federal Treasury or to those who pay the money in? What is your concept of that?

Mr. STALNECKER. The ultimate use of the funds is obviously going to go to the beneficiary of the funds, and therefore when one looks at the ultimate disposition of the fund assets, they belong to whomever receives the benefits.

To the extent that the collection of taxes and the payment of benefits is mandated by the Congress and the payments are not voluntary ones, I think one can also make a statement that the funds collected and then disbursed by the Congress belong to the U.S. Government, or at least they are controlled by the U.S. Government and the policies adopted relating to benefits and taxation from Congress.

I am not a lawyer, so I am not completely aware of the distinction.

Senator STENNIS. Well, I would just make this point, that throughout the life of the social security program, I have understood always that the government was merely the custodian as a trustee. The so-called tax is imposed by law and by the authority of the Congress. However, the money still belongs and is set aside for the beneficial use of the people who paid the taxes. The funds are impressed with a trust relationship.

That is why I say that the earnings, however obtained, belong to the trust funds. You have some problems regarding maturities, interest rates, and other matters. I am no expert in that field. I am standing on the single point that the funds are trust funds and the earnings belong to the beneficiaries.

Mr. STALNECKER. I agree, and the points that I am trying to make in my testimony and the technical corrections in the law that we are suggesting would allow the trust funds to earn an equitable return relative to other purchasers of Treasury obligations. We want the funds to be invested at the same rate.

Senator STENNIS. Thank you.

Senator ARMSTRONG. Senator Proxmire.

Senator **Proxmire**. Thank you, Mr. Chairman. I do appreciate your letting us sit in. I will be as brief as I can.

Secretary Stalnecker, you said the trust fund investment policy should not, and I quote, "be dictated by the happenstance of current relationships between short-term and long-term interest rates."

The implication of your remarks is that any loss of interest is a temporary development. However, the funds earned less than the current Treasury rate in 17 of the last 21 years, as I indicated in my statement. Do you regard that record as satisfactory?

Mr. **Stalnecker**. I would say that investment performance cannot be judged a priori. It is only with the benefit of 20 years' experience that we know that the current trust fund assets are earning less than the current market rates.

I think that the relevant factor here is that when the trust fund purchases a security or the Treasury issues a security to the trust fund, the rate of return on that trust fund purchase should be based on the same terms of exchange that a private individual is going to engage in the transaction with the Treasury. Therefore, if the Treasury obtains 5-year money from a private individual at 13 percent, the trust fund should also earn 13 percent on a 5-year security. If the Treasury only gets 12 percent on 1 year from the private market, it should pay only 12 percent to the trust funds for a 1-year investment.

Senator **Proxmire**. That is fine. Then, why would you have any trouble with the proposal that we make that the rate of return be the same as the rate of return for all private investors?

Mr. **Stalnecker**. The Treasury's major reservations on the concept of a savings account, which are also the reservations we have with the current system of just having a greater than 4-year rate regardless of the maturity, is what you are essentially talking about is a very short-term investment. It is one that has instant liquidity. It is almost like a money market fund or a 1-month investment because the rate is adjusted every month. The Treasury would say that if such an account were established, the rate on such an account should be equal to whatever the market rate is on a short-term investment.

Senator **Proxmire**. Why a short term? Most of that money would be left in the account. We know that on the basis of all of our experience it will be left in, not for 30 days or for a year but for 1 number of years.

Mr. **Stalnecker**. That money should be invested long term at a long-term rate, so that the trust funds gain the benefit of that long-term rate. For instance, right now the rate on the 3-month Treasury bill is about 12¼ percent or a little bit more than that. On the 10-year note it is almost 14 percent. So, that if the Treasury would receive money for 3 months from a trust fund because it was anticipated that money would be going out 3 months hence, the trust fund would only get 12¼ on it, but if the trust fund had moneys to invest for 10 years based on projected cash needs, the trust fund should be compensated for placing money for a longer period of time just like the private investor is and earn the close to 14 percent rate.

Now, it so happens that in certain instances over the past few years this relationship was inverted, and short rates were higher than long-term rates. In those market conditions the trust fund would also get whatever rate the market was accepting for the same maturity instrument.

So, our whole view is that the trust funds should continue to be invested in the maturity that is suitable for their needs, and the interest rate that they earn should not be based on some statutory formula that says that any security earns at the rate for 4 years or more, but it should earn the same rate that a private investor would get on the same maturity instrument.

Senator **Proxmire**. One more point, and I apologize for taking as much time as I am. But it seems very, very clear to me that the one perception that the American people will accept, the social security recipients will accept, the taxpayers will expect, is that you get exactly the same return as everybody else gets in the free market.

It seems that is one we can sell, that is one that is understandable. Nobody is getting shortchanged. You cannot come up as we have come up today and say you have lost $18 billion. You would have had another strategy. We are just treating them exactly the way we treat everybody else.

Mr. **Stalnecker**. I agree with that, but I would also say that although the comparison looks very bad now, given the increase in rates that has occurred—at the time that the transactions between the trust fund and the Treasury were entered into over the past decades, the rates were very close to a market rate. And it is just a happenstance that rates have risen, that they now appear to be disadvantageous rates. At the time the investments were made the rates were very close to the market rates.

Senator **Proxmire**. Thank you very much, Mr. Chairman.

Senator **Armstrong**. Mr. Stalnecker, how long have you been at Treasury?

Mr. **Stalnecker**. A little over 1 year.

Senator **Armstrong**. What did you do before you came to the Treasury?

Mr. **Stalnecker**. I was a portfolio manager at a commercial bank in the investment area.

Senator **Armstrong**. I did not know that, but something about your testimony made me believe that that was your background, and based on that I want to ask you this question. If the fund manager, the trustees or the Secretary of the Treasury or somebody had the discretion to simply manage to maximize the return, are you confident that in that circumstance it would be possible to do substantially better than one of the formulas suggested; that is, the trust fund would earn substantially more?

Mr. **Stalnecker**. No; I do not. I do not believe the record of private investment managers would indicate that they could significantly enhance the trust fund's yields. And I think that some of the studies that have been done over the years would indicate that. Forbes Magazine, for instance, every year puts out a survey of mutual fund results, and it just so happens that I have them with me.

Now, you will have to remember that when you are the owner of a longer term asset in the marketplace, you have to take into account capital market value, price fluctuations on your assets as well as just the current income stream. And for 1981, the 12 months ending June 30, 1981, most of the mutual funds that invested in fixed rate assets, Government bonds and corporate bonds that are similar to those in maturity in terms of the maturity that the social security trust fund invests in, most of those funds had a negative return when in addition to the interest income earned you took into account the capital loss suffered on the market value.

That has been the case of these funds. Most of these funds over the period from 1968 to 1981, when you take into account loss of market value actually earned less than 5 percent on their assets. So, that taking into account the social security trust fund's returns over that time period and the fact that there was no capital loss incurred, the social security trust funds have not done that badly vis-a-vis longer term private investors in the marketplace.

So, I do not think there is any evidence that active management of the funds would significantly increase their yield.

Senator MOYNIHAN. Would the Senator yield for a question?

Senator ARMSTRONG. Of course.

Senator MOYNIHAN. Now, hold on. You have a situation at Treasury which is totally different from that of a broker or money manager, which is you have available to you a bond which has no downside; and I think you could outperform most people in that relation. You cannot lose and you can win.

Mr. STALNECKER. I agree with you. If you are talking about a situation that whoever manages this trust fund has access to bonds they can always be redeemed at par, it is a no-lose situation. In that kind of an instance it would earn significantly higher than the market could be earned.

But, I think, if such a trading activity was contemplated, the Treasury Department would have to look very strongly at the desirability of issuing these par value specials that can be redeemed willy-nilly.

Senator MOYNIHAN. I can see that, too, but let us be clear, sir, the present law is written to insure that you never lose, and it enables you to win rather consistently in a rising market.

Mr. STALNECKER. It does allow the trust funds to cash in for emergency cash needs the securities it holds at market values.

Senator MOYNIHAN. For emergencies?

Mr. STALNECKER. For unforeseen cash needs, yes.

Senator MOYNIHAN. That is part of the statute?

Mr. STALNECKER. No; it is not. Over the years that has been the interpretation.

Senator MOYNIHAN. Mr. Secretary, we know a little bit about the statute. We write it. The Secretary could turn those bonds in such a way that in a rising market in the last 20 years he need never have lost but very fractional amounts, and he did not, a sequence of them did not, but they could have done, is that not right, sir?

Mr. STALNECKER. I believe there is no prohibition to that kind of activity.

Senator MOYNIHAN. That is the point I wanted to make.

Senator **Armstrong**. To return to the point I was going to pin down, in my view, Mr. Stalnecker, the question is not really so much whether or not a Secretary of the Treasury or some other Government money manager could be better than private manager. I think it is obvious, the potential for the Government to do better than the private sector is obvious for the reason that Senator Moynihan pointed out. No private money manager would have an opportunity to be held harmless against downside potential.

But the question I was getting at is whether or not that kind of active management would be better than a formula approach, and I want to be clear I understand what you responded. In your judgment there is not any evidence to suggest that there would be. You basically do not favor more discretion for trustees or for the Secretary, but along with Senator Proxmire and Mr. Shamansky you favor, from your testimony, actually rather more restrictions and more carefully defined parameters on the discretion than already exist.

Mr. **Stalnecker**. That is right. The Treasury would have some technical problems with the concept of a savings account and paying out what is basically an intermediate or longer term rate to what is a short-term account. But basically we agree with the concept that there should not be any fund management discretion on the part of the trustees.

Senator **Armstrong**. I listened intently to the exchange between you and Senator Proxmire, and it seems that the distinction between the position of the Treasury as you have outlined it and that of Senator Proxmire as enunciated really is quite small. Both seem to be agreeing that rates should fluctuate. The question is whether or not the trust funds should have the rate of all outstanding securities or whether or not they should benefit from whatever rate reflects their portfolio maturities.

Is that not the distinction to be drawn?

Mr. **Stalnecker**. I believe that Senator Proxmire's accounts, savings type accounts, would contemplate keeping the trust funds earning at a rate that reflects current market conditions.

Senator **Armstrong**. Of all outstanding———

Mr. **Stalnecker**. All outstanding Treasury securities.

Senator **Armstrong**. And I thought you testified it should be related in some segmented way.

Mr. **Stalnecker**. To the maturities that are actually used for the investment of the funds.

Senator **Proxmire**. If the chairman would yield on that.

Senator **Armstrong**. Of course.

Senator **Proxmire**. My testimony indicated I would give the Secretary the discretion, to do exactly that, and Senator Dole asked me that specific question, and I would give him that discretion so we could take care of that technical objection.

Mr. **Stalnecker**. I think it is more than just a technical suggestion because your policy would involve investing all of the fund's assets in the same pool basically without regard to maturity choice. That pool would earn at a rate recalculated every month based on that month's average rate on outstanding Treasury securities.

The suggestion that I make is that the maturities of the fund's investments be selected the way they are currently based on the fund's projected cash needs, but that the rate earned on those investments not be determined by this greater-than-4-years formula that is part of the statute now, but be determined by the current yield in the marketplace on the same maturity obligation issued by the Treasury.

Senator Proxmire. Why do you have to worry about the maturity concept anyway? They are all redeemable at par.

Mr. Stalnecker. The reason is that if interest rates, for instance, would fall and the trust funds are loaning money to the Treasury for a long period of time, they should benefit from the long-term interest rate that any other investor can receive.

We do not believe that a short-term account of the type you are suggesting should earn at the longer term interest rates available to long-term investors. If your approach were adopted and all of the funds were placed into a short-term account that was available upon demand, then we would suggest that only the short-term Treasury rates be utilized.

Senator Proxmire. You see, what I do not do is call on the Secretary of the Treasury to use discretion or to speculate. I would simply provide that the return be automatic. That would take care of the political problem, certainly, and it seems to me would also take care of the equity problem. You do not have to worry about maturities, you do not have to worry about management. You would get the return that the investor g[illegible] And over the past 21 years I pointed out it would make a differ[illegible] of $18 billion in the fund.

Mr. Stalnecker. But if the trust funds were, let us say, in a healthy position so that the funds were growing over time instead of shrinking and that the funds in fact were longer term instruments, which I believe they were contemplated back in 1960 when the statute that we currently operate under was drafted, then you would have a situation where the funds would be essentially long term in nature, and they would be earning a short-term rate or an intermediate-term rate. If you take short, intermediate- and long-term rates, the rate of return earned by the funds would not be related to the length of their assets. In certain economic circumstances, especially those which are normally in existence when longer term rates are higher than short-term rates, the funds would not be equitably treated because they would be earning a composite rate that reflects all of the rates available, not the longer term rate.

Senator Proxmire. You just have a notion they ought to be related to a maturity when there is no maturity here. It is a matter of putting it in a fund that has a savings account context and then paying the rate of interest that the Federal Government pays.

Mr. Stalnecker. But the concept is to a certain extent artificial because the Treasury does not offer a composite bond to the public.

Senator Proxmire. I understand.

Mr. Stalnecker. What I am trying to do here is suggest a way to reconcile your desire and the Treasury Department's desire for equitable treatment of the trust funds with our current issuance of securities. Our current issuance of securities contemplates a firm, fixed maturity date and then a market-determined rate that goes along with that. We believe that it is desirable to pay the trust funds the same rate that the private investor can earn, but we argue with the idea that the trust fund should earn an artificial composite rate with no maturity on their funds when that may or may not be equitable. It could be equitable in certain circumstances. It could be inequitable to the trust funds under others. So, that is why we think a maturity and a comparable yield is important.

Senator ARMSTRONG. In summary—and we are running a bit behind schedule—but in summary it is your view that because some investors receive a higher yield in consequence of accepting a higher risk and that is a longer term, that it simply is unjust for someone who does not take that risk to get the same kind of higher yield.

Mr. STALNECKER. Basically, yes, sir.

Senator ARMSTRONG. I have one additional question for Mr. Ballantyne. You are the chief actuary of the social security system, and what we are really talking about is managing the reserves of that fund which you are responsible for studying and projecting.

At the present time what is the extent of that reserve in dollars, and also as a percentage of the payments to be made by the social security system?

Mr. BALLANTYNE. OK.

Senator ARMSTRONG. Is that spelled out in your testimony?

Mr. BALLANTYNE. Yes. We have the answers for the trust funds. As of the end of March the total for all four trust funds combined was $47.6 billion.

Senator ARMSTRONG. And what percentage is that of a year?

Mr. BALLANTYNE. For the three trust funds that are financed out of the payroll taxes, at the beginning of 1982 we had about 22 percent of 1 year's outgo in the funds.

Senator ARMSTRONG. For the benefit of the record I am going to ask a question which I already know the answer, but I think it should appear at this point in the hearing record just in case some unsuspecting person should be reading; at this point they should know the answer to the question I am about to propound to you.

How does that ratio compare with the past?

Mr. BALLANTYNE. Well, of course it is lower than it ever has been in the past. At the beginning of the 1970's the ratio stood at about a 100 percent for OASD combined, so it has been dropping steadily since that point.

Senator ARMSTRONG. Now, the subject of this hearing is actually the management and the interest yield of these funds that are under management, but just since we touch upon the subject, in your judgment is 22 percent an adequate ratio to be maintained?

Mr. BALLANTYNE. Well, it is enough now to pay benefits, but the problem is that this ratio is dropping, and next year for the three trust funds combined under our intermediate 2(b) assumptions we will have only 16 percent trust fund ratio, and then it falls to 10 percent. And then the three funds, if they could be combined and you would have interfund borrowing among all three funds which we do not have under present law, would become exhausted by 1984.

Senator ARMSTRONG. I do not think I will pursue that any further other than to note for anybody who might happen to read the record of this hearing—and I often wonder, I say to my colleagues who, if anybody, actually does read such transcripts—but if anybody is interested in this, there is extensive testimony on it that ought to be considered.

We are grateful to the witnesses. We thank you very much for the material you presented.

Finally, the committee is very pleased to present two very old friends, Dr. Alice Rivlin, Director, Congressional Budget Office, and Mr. Robert J. Myers, Executive Director, National Commission on Social Security Reform, one of the others of whom I trust will give us a definitive response to all of the questions that have been previously raised.

Answers to Questions Submitted to Mark Stalnecker
from Senator Boren

1. What is the current yield on Social Security Trust Fund assets?

   Answer.

   As indicated in the prepared testimony, the annualized earning rate for the Old Age and Survivors Insurance Trust Fund was 10.8 percent as of September 30, 1981 and 11.3 percent as of May 31, 1982.

2. Why are the trust fund monies invested at low rates of interest? This undoubtedly deprives the funds of substantial income.

   Answer.

   The social security laws authorize the Secretary of the Treasury to issue special nonmarketable public debt obligations to the trust funds. Under a 1960 amendment, these special obligations bear interest determined by a statutory formula which seeks to approximate the interest rates the Treasury would pay in the market for borrowing for a period of four or more years. Under this statutory formula, trust fund investments in special obligations made during the month of June 1982 bear interest at 13-1/4 percent.

3. Do you believe it is fair to expect the Social Security System to incur losses in revenue due to current investment policies, in order to reduce or attempt to control the national debt?

   Answer.

   The Treasury Department does not believe it is fair for the Social Security System to incur investment revenue losses in order to reduce the national debt. As indicated in the prepared testimony, the social security funds should earn interest on their investments at rates equivalent to the rates the Treasury would be required to pay for borrowings in the market for comparable periods. The testimony suggested three changes to the statutory interest rate formula which would provide greater assurance of a more equitable and market-related return to the funds in the future.

Answers to Questions Submitted to Mark Stalnecker
by Senator Moynihan

1. The Social Security Amendments of 1960 established the presumption that Social Security moneys would be invested in "special issue" bonds. They could be invested in marketable U.S. government obligations only when it is "in the public interest." About 7 percent of Social Security's investments are in marketable obligations. Why was this deemed to be in the public interest? What other circumstances might arise in which this type of investment would be preferable to investing in special issues?

Answer.

The investment of the Social Security and other trust funds in marketable U.S. Government obligations has been deemed to be "in the public interest" when such investment could provide needed support to the Government securities market and at the same time benefit the trust funds. The use of trust funds for market support purposes began in late 1947 and primarily involved trust fund purchases of Treasury securities. Specifically, the Treasury Department used these purchases in order to ensure coverage of its fixed price new issues when the market for such issues was unfavorable. This investment in marketable securities was extended during the 1966 credit crunch to the purchase of some agency issues by the trust funds in order to minimize the market impact of Federal borrowing activities. In all cases in which the trust funds were invested for market support purposes the yields on such investments were higher than the interest rates which were then available on special issues.

Since the 1960's, the practice of investing trust fund moneys in marketable U.S. Government obligations for market support purposes has been discontinued. Since the Treasury Department normally auctions its new marketable issues, thus avoiding the risk of changing market sentiment and essentially ensuring the coverage of the issues at prevailing yield levels, there is no need to use such investments to support the Government securities market. In addition, the Treasury Department has acted to minimize the market impact of Federal borrowing activities by establishing a regular, predictable cycle of Treasury security issuance, by spreading Treasury maturities more evenly over time, and by consolidating the borrowing of various Federal agencies through the use of the Federal Financing Bank.

It should be noted that prior to February 15, 1980, marketable Treasury obligations held by the Social Security trust funds were rolled over into comparable marketable securities when they matured. After that date, due to the deterioration of some of the funds, the decision was made to redeem such obligations upon maturity and reinvest the proceeds in nonmarketable par value specials, which could be tailored to meet the changing needs of the funds.

With respect to future trust fund investment, the Treasury Department does not foresee any circumstances arising which would make investing in marketable U.S. Government obligations preferable to investment in special issues, provided that the interest rates on such specials are tied to market rates. In order to assure the trust funds a more market-related rate of return than is currently available, the Department has recommended three changes to the statutory interest rate formula for special issues in the prepared testimony

2. More than half of the investments in marketable obligations carry interest rates under 5 percent. Has Treasury calculated whether it would be to Social Security's advantage to redeem those bonds before maturity, pay the penalty, and re-invest the money in newly issued, higher-yielding special issues? If not, could you run this calculation for us?

Answer.

The Treasury Department is currently developing procedures for implementing the Interfund Borrowing Act. In conjunction with this work, the Department has determined that the Social Security trust funds would incur net book losses if the low-yielding marketable obligations which they now hold were redeemed before maturity and reinvested in special issues.

Dr. RIVLIN.

STATEMENT OF DR. ALICE RIVLIN, DIRECTOR, CONGRESSIONAL BUDGET OFFICE, WASHINGTON, D.C.

Ms. RIVLIN. Thank you, Mr. Chairman.

You are far, far along in the discussion of the subject, so let me be very brief. No one needs to remind you of reasons for concern with the balances of the social security trust funds. Today's hearing focuses on the interest accruing to the funds, which is a relatively small, though not totally insignificant, part of the income of the funds, about 2 percent, and it focuses on the investment practices.

The current investment practices are familiar to you. Let me just pick up and read the end of my statement beginning at the top of page 5.

The policy of investing trust funds balances in relatively long-lived securities has meant that, as interest rates rose rapidly in recent years, the average yield to the trust funds has lagged behind market rates. During the 12-month period ending June 30, 1981, the average yield on the holdings of the trust funds was 9.1 percent with an average market yield on long-term Government bonds of about 11.7 percent. Because the funds have received lower-than-current-market rates of interest, it has appeared to some observers that the funds have provided an implicit interest subsidy to the Treasury.

Defenders of the current practices point out that the reverse can be true—average yields to the trust funds can exceed current market rates when interest rates fall. Moreover, when interest rates are rising, the current privilege of redeeming outstanding special issues at par offers a substantial financial advantage to the trust funds relative to other investors in Government securities. For example, $483 million in 7⅛ percent 1992 special-issue bonds were redeemed at par in March 1982; at the same time, marketable 7¼ percent 1992 bonds were being purchased on the New York exchange at only 65 percent of face value. In essence, this constitutes a general-revenue transfer to the trust funds that may offset the effect of lower-than-current-market yields.

The relatively low interest rates received by the trust funds have prompted a rethinking of current investment practices. One possibility would be to design an investment policy whose chief goal was to maximize the investment income received by the trust funds, subject to reasonable concern for their safety. Indeed, Senator Proxmire's original bill would require that the trust fund balances be invested in U.S. Government issues—so as to secure the maximum possible interest yield, commensurate with the safety of the trust funds.

The bill as introduced would permit the trust funds to continue to purchase special-issue securities. In addition, to maximize income, it would require redemption of low-yielding special issues at par and reinvestment in new higher-yielding special issues both upon enactment and whenever interest rates rose in the future. If interest rates were to fall, the trust funds would have the advantage of continuing to receive the higher rates until those special issues matured.

Initially, enactment of S. 1528 would increase trust fund yields because it would require the trustees to redeem the existing low-yielding portfolio at par, and to reinvest the reserves either in special-issue bonds or in marketable Government securities at current rates. In addition, in periods of rising interest rates, S. 1528's redemption policy would raise the cost of the Treasury borrowing from the trust funds relative to the cost of borrowing from the general public. Finally, if the trust funds invested in marketable securities rather than special issues, they could experience either capital gains or capital losses, depending on whether interest rates decline or rise and on whether short- or long-term securities are acquired.

A different approach, recommended by the General Accounting Office in 1975, and I gather now endorsed by Senator Proxmire, would treat trust fund reserves as if they were in a Government savings account. The trust funds would no longer hold specific Government securities, but rather would have their funds deposited in an account with the Treasury. Interest paid on this account would equal the current market yield on all outstanding Government securities, determined on a daily, weekly, monthly, or other basis. Existing holdings of special issues would be redeemed at par, but marketable securities would be held until maturity.

If the GAO proposal was implemented immediately, the average yield on the trust funds would increase substantially. If there was significant decline in interest rates, however, future trust fund yields could be lower than those under current law.

Implementation of this investment alternative would retain some subsidy from the Treasury to the trust funds. First, the initial redemption of special-issue holdings at face value would continue the current favorable treatment of the trust funds compared with other lenders. Second, an interest rate based upon all outstanding marketable Government securities would generally be higher than a short-term rate. Thus, the trust funds would benefit from including long-term rates in the interest calculation without taking any of the risks associated with long-term investments, as the representative of the Treasury has pointed out.

A variant of the GAO proposal would have interest paid to the trust funds computed on the basis of rates on short-term Government securities only. Since the trust funds must be able to withdraw reserves whenever necessary to pay benefits, they more closely resemble holders of short-term than long-term Government securities.

Finally, on the potential effects on trust fund income, the potential increase in interest income received by the trust funds under alternative investment policies would depend primarily on the future level of balances and on future interest rate movements. One way to compare different policies is to determine what effect they would have had on interest income in 1981.

In the 12-month period ending June 30, 1981, the actual average yield to the trust funds was 9.1 percent, for an interest income of about $3.9 billion. If the entire portfolio had been redeemed at par and invested in 91-day Treasury bills throughout this period, the corresponding figures would have been 13 percent and $5.6 billion, an increase of 43 percent. Since this was a period of near-record-high interest rates, this estimate represents a reasonable upper bound for what this change in investment policy might imply for trust fund income. But even this increase would have only amounted to about 1 percent of the total income on the social security trust funds.

The potential effect of any investment policy on income to the trust funds diminishes as trust fund balances decline. Although an approach similar to the GAO plan might have increased trust fund balances by as much as $15 billion over the last 20 years, those were years of relatively large balances and rising interest rates. The current CBO projections of the combined OASDHI trust fund reserves show balances declining from $45.3 billion at the end of fiscal year 1981 to $15.1 billion at the end of 1985. Thus, even if yields were increased, total interest income received by the funds would still decline during this period.

In summary, Mr. Chairman, it is worthwhile to reexamine the investment practices of the social security trust funds. Of the different options available, those involving a savings account approach appear attractive, both because of their simplicity and because they would align the yields of the trust funds with current Treasury borrowing costs.

A change from current investment practices to a savings account approach would initially increase the yields to the trust funds, but the effect on long term yields would depend on future movements in interest rates. Nevertheless, no investment strategy could increase trust fund income by more than a small percentage or could insure that the trust funds would continue to pay benefits in a timely manner. Thank you, Mr. Chairman.

[The prepared statement of Ms. Rivlin follows:]

STATEMENT BY

Alice M. Rivlin
Director
Congressional Budget Office

Mr. Chairman, I welcome this opportunity to discuss the investment policies of the Social Security trust funds, and the effects of these policies on the financial status of the funds. Senator Proxmire has proposed legislation that would align the yields of securities held by the trust funds with interest rates currently available to other investors in federal securities. I will comment on the potential effect of this proposal on trust fund balances and its advantages and drawbacks relative to other investment practices that might be pursued by the Social Security Board of Trustees.

CURRENT CONCERNS WITH TRUST FUND BALANCES

The Social Security system is a matter of concern today for two reasons. First, the balance in the Old-Age and Survivors Insurance (OASI) trust fund—the largest of Social Security's trust funds—has declined rapidly in recent years. The OASI fund would have become unable to meet all of its benefit payments in 1982 had not Public Law 97-123 been enacted. That legislation permits the OASI fund to borrow from the Disability Insurance (DI) and Hospital Insurance (HI) trust funds until December 31, 1982. Although the OASI fund may then borrow reserves sufficient for six months of benefit payments, this action would only postpone the funding problems until July 1983. Even if the interfund borrowing authority were extended indefinitely, the problem of insufficient balances in all three trust funds would occur sometime in 1984. Under current Congressional Budget Office (CBO) projections, the combined reserves of the OASI, DI, and HI funds will fall below 12 percent of annual outlays during fiscal year 1984, and begin fiscal 1985 at less than 8 percent. This will create serious cash flow problems for the trust funds (see Table 1).

TABLE 1. PROJECTIONS OF SOCIAL SECURITY TRUST FUND OUTLAYS, INCOMES, AND BALANCES (By fiscal year, in billions of dollars)

	1981	1982	1983	1984	1985	1986	1987
			Old-Age and Survivors Insurance				
Outlays	122.3	138.8	152.7	168.4	184.8	201.9	219.9
Income a/	121.6	127.6	142.9	149.1	167.8	185.1	201.2
Year-End Balance	23.8	12.6	2.8	-16.6	-33.5	-50.5	-69.1
Start-of-Year Balance (as percent of outlays)	20.1	17.2	8.3	1.7	-9.0	-16.6	-22.9
			Disability Insurance				
Outlays	17.3	18.5	19.3	20.0	20.4	21.0	22.2
Income a/	13.0	21.6	19.2	28.7	35.7	41.6	46.6
Year-End Balance	3.4	6.4	6.2	14.9	30.2	50.8	75.1
Start-of-Year Balance (as percent of outlays)	44.4	18.3	33.1	31.2	73.1	143.6	228.5
			Hospital Insurance				
Outlays	29.3	34.3	39.9	46.2	52.9	60.4	68.9
Income a/	32.9	37.2	41.0	45.1	50.3	57.7	63.1
Year-End Balance	18.1	21.0	22.1	21.1	18.4	15.7	10.0
Start-of-Year Balance (as percent of outlays)	49.5	52.8	52.6	48.0	39.8	30.5	22.8
			Combined OASI, DI, and HI				
Outlays	168.8	191.6	211.9	234.6	258.2	283.3	311.0
Income a/	167.4	186.3	203.1	222.8	253.8	284.4	310.9
Year-End Balance	45.3	40.0	31.2	19.4	15.1	16.1	16.0
Start-of-Year Balance (as percent of outlays)	27.7	23.7	18.9	13.3	7.5	5.3	5.2

SOURCE: CBO estimates based on baseline assumptions used for S. Con. Res. 92, as passed by the Senate on May 21, 1982, modified for 1982 cost-of-living adjustment of 7.4 percent.

NOTE: Minus sign denotes a deficit.

a/ Income to the trust funds is budget authority. It includes payroll tax receipts, interest on balances, and certain general fund transfers. Income in 1983 reflects interfund transfers as authorized under Public Law 97-123.

A second reason for concern with the growth of Social Security outlays arises from efforts to cut the size of total government spending and to reduce the federal deficit. Social Security outlays have increased from 2.3 percent of GNP in 1960 to a projected level of about 6 percent of GNP this year. They now represent more than one-fourth of the total federal budget, and nearly 35 percent of nondefense spending. Continued rapid growth in Social Security outlays, combined with the proposed growth of defense expenditures, will make it difficult to reduce federal spending and move toward a balanced budget.

Although the Congress acted last year to reduce outlays from the trust funds by approximately $21 billion for fiscal years 1982 through 1986, further steps will have to be taken in order to continue paying all benefits in a timely fashion. The Congress could increase trust fund balances either by reducing outlays or by increasing trust fund income. The OASI, DI, and HI funds rely on payroll tax receipts for the bulk of their income; interest payments on reserves make up about 2 percent. The Proxmire bill, S.1528, focuses on increasing the interest income received by the trust funds.

CURRENT INVESTMENT PRACTICES

The current investment practices of the Social Security trust funds—including Supplemental Medical Insurance (SMI)—are determined in part by law and in part by guidelines established by the Department of the Treasury. Under the provisions of the Social Security Act, all trust fund monies not immediately required for the payment of benefits or administrative expenses must be invested in obligations that are guaranteed by the U.S. government. The Secretary of the Treasury, who is the Managing Trustee, must invest in special public-debt obligations--"special issues" available only to the trust funds--except when he determines that the purchase of marketable government securities is "in the public interest." Interest rates on new special issues are set by law at the average current yield on all marketable Treasury securities not due or callable for at least four years. The maturities of new special issues are to be determined "with due regard for the needs of the trust funds." Finally, the Social Security Act specifies that special-issue obligations are redeemable at par plus accrued interest regardless of market prices of comparable securities, whereas any marketable securities sold by the trust funds must be sold at their market prices.

In practice, the Treasury has purchased marketable securities only rarely; they now constitute less than 7 percent of total trust fund holdings. Maturities for new special issues have been chosen so that approximately the same percentage of all special-issue holdings within a trust fund will mature in each of the next 15 years. Although the Managing Trustee has authority to redeem special-issue obligations at any time at par, the Treasury has followed a policy of not using this option except when it has been necessary to redeem bonds in order to meet benefit payments. When bonds must be redeemed in order to meet payments, those special issues closest to maturity are cashed in first and, if there are bonds of differing rates maturing in the same year, those with the lowest rates are redeemed first. Investment practices for certain other trust funds such as the Civil Service Retirement fund are similar to those for Social Security.

The policy of investing trust fund balances in relatively long-lived securities has meant that, as interest rates rose rapidly in recent years, the average yield to the trust funds has lagged behind market rates. During the 12-month period ending June 30, 1981, the average yield on the holdings of the trust funds was 9.1 percent ~~compared with an average 91-day Treasury Bill rate of 13.0 percent~~ and an average market yield on long-term government bonds of about 11.7 percent. Because the funds have received lower-than-current-market rates of interest, it has appeared to some observers that the funds have provided an implicit interest subsidy to the Treasury.

Defenders of the current practices point out that the reverse can be true--average yields to the trust funds can exceed current market rates when interest rates fall. Moreover, when interest rates are rising, the current privilege of redeeming outstanding special issues at par offers a substantial financial advantage to the trust funds relative to other investors in government securities. For example, $483 million in 7-1/8 percent 1992 special-issue bonds were redeemed at par in March 1982; at the same time, marketable 7-1/4 percent 1992 bonds were being purchased on the New York exchange at only 65 percent of face value. In essence, this constitutes a general-revenue transfer to the trust funds that may offset the effect of lower-than-current-market yields.

~~ALTERNATIVE INVESTMENT POLICY OPTIONS~~

The relatively low interest rates received by the trust funds have prompted a rethinking of current investment practices. One possibility would be to design an investment policy whose chief goal was to maximize the investment income received by the trust funds, subject to reasonable concern for their safety. Indeed, Senator Proxmire's original bill would require that trust fund balances be invested in U.S. government issues "so as to secure the maximum possible interest yield, commensurate with the safety of the trust funds." The bill as introduced would permit the trust funds to continue to purchase special-issue securities. In addition, to maximize income, it would require redemption of low-yielding special issues at par and reinvestment in new higher-yielding special issues both upon enactment and whenever interest rates rose in the future. If interest rates were to fall, the trust funds would have the advantage of continuing to receive the higher rates until those special issues matured.

Initially, enactment of S.1528 would increase trust fund yields because it would require the Trustees to redeem the existing low-yielding portfolio at par, and to reinvest the reserves either in special-issue bonds or in marketable government securities at current rates. In addition, in periods of rising interest rates, S. 1528's redemption policy would raise the cost of the Treasury borrowing from the trust funds relative to the cost of borrowing from the general public. Finally, if the trust funds invested in marketable securities rather than special issues, they could experience either capital gains or capital losses, depending both on whether interest rates decline or rise and on whether short- or long-term securities are acquired.

A different approach, recommended by the General Accounting Office ~~(GAO)~~ in 1975,① would treat trust fund reserves as if they were in a government savings account. The trust funds would no longer hold specific government securities, but rather would have their funds deposited in an account with the Treasury. Interest paid on this account would equal the current market yield on all outstanding government securities, determined on a daily, weekly, monthly, or other basis. Existing holdings of special issues would be redeemed at par, but marketable securities would be held until maturity.

If the GAO proposal was implemented immediately, the average yield on the trust funds would increase substantially. If there was a significant decline in interest rates, however, future trust fund yields could be lower than those under current law.

Implementation of this investment alternative would retain some subsidy from the Treasury to the trust funds. First, the initial redemption of special-issue holdings at face value would continue the current favorable treatment of the trust funds compared with other lenders. Second, an interest rate based upon all outstanding marketable government securities would generally be higher than a short-term rate. Thus, the trust funds would benefit from including long-term rates in the interest calculation without taking any of the risks associated with long-term investments, as the representative of the Treasury has pointed out.

A variant of the GAO proposal would have interest paid to the trust funds computed on the basis of rates on short-term government securities only. Since the trust funds must be able to withdraw reserves whenever necessary to pay benefits, they more closely resemble holders of short-term than long-term government securities.

Finally, on the potential effect on trust fund incom

~~POTENTIAL EFFECTS ON TRUST FUND INCOME~~

The potential increase in interest income received by the trust funds under alternative investment policies would depend primarily on the future level of balances and on future interest rate movements. One way to compare different policies is to determine what effect they would have had on interest income in 1981. In the 12-month period ending June 30, 1981, the actual average yield to the trust funds was 9.1 percent, for an interest income of about $3.9 billion. If the entire portfolio had been redeemed at par and invested in 91-day Treasury bills throughout this period, the corresponding figures would have been 13.0 percent and $5.6 billion, an increase of 43 percent. Since this was a period of near-record-high interest rates, this estimate represents a reasonable upper bound for what this change in investment policy might imply for trust fund income. But even this increase would have only amounted to about 1 percent of the total income of the Social Security trust funds.

The potential effect of any investment policy on income to the trust funds diminishes as trust fund balances decline. Although an approach similar to the GAO plan might have increased trust fund balances by as much as $15 billion over the last 20 years, those were years of relatively large balances and rising interest rates. The current CBO projections of the combined ~~OASI, DI, and HI~~ trust fund reserves show balances declining from $45.3 billion at the end of fiscal year 1981 to $15.1 billion at the end of 1985. Thus, even if yields were increased, total interest income received by the funds would still decline during this period.

~~CONCLUSION~~

In summary, Mr. Chairman it is worthwhile to reexamine the investment practices of the Social Security trust funds. Of the different options available, those involving a savings account approach appear attractive, both because of their simplicity and because they would align the yields of the trust funds with current Treasury borrowing costs. A change from current investment practices to a savings account approach would initially increase the yields to the trust funds, but the effect on long-term yields would depend on future movements in interest rates. Nevertheless, no investment strategy could increase trust fund income by more than a small percentage or could ensure that the trust funds would continue to pay benefits in a timely manner.

end tape 3

Questions Submitted by Senator Boren

Q. What would be the economic impact of an alternate investment program for these trust funds?

A. While there may be some minor differences between specific investment alternatives, it is unlikely that there would be a significant economic impact resulting from any change in investment practices. Social Security reserves are too small in relation to total federal borrowing to have much of an effect on capital markets. Even if the trust funds invested in marketable securities as S. 1528 would permit, this would simply substitute one type of federal security for another and would not change total federal borrowing.

Q. Would such a transfer of monies endanger the safety and liquidity of Social Security?

A. The investment policy prescribed in S. 1528 need not result in any additional risk for the trust funds, although there is the possibility that active portfolio management could lessen trust fund income if the trustees acquired marketable securities and incorrectly predicted the movement of interest rates. On the other hand, one likely strategy under S. 1528 would be to invest in short-term securities whenever short-term rates exceeded long-term rates, but to invest in special issue securities at any other time. Special issues, with their par redemption aspect, would offer great advantages to the trust funds. Since the Managing Trustee would be required to maximize trust fund income, he would be required to redeem the special issues at par anytime interest rates rose. This would enable the trust funds to increase their income any time rates rose, and maintain high yields whenever interest rates fell.

Q. Do you suppose the proposed investment policies might considerably aid the Social Security system in its struggle for solvency?

A. Immediate implementation of the investment practices embodied either in S. 1528 or the GAO proposal would increase trust fund income in the near-term. Interest income, however, is too small as a component of trust fund income for any change in investment policy to be an answer to Social Security's solvency problem.

Senator ARMSTRONG. Thank you, Dr. Rivlin. Mr. Myers.

STATEMENT OF ROBERT J. MYERS, EXECUTIVE DIRECTOR, NATIONAL COMMISSION ON SOCIAL SECURITY REFORM, WASHINGTON, D.C.

Mr. MYERS. Mr. Chairman, I am pleased to be here to discuss the investment policy of the four social security trust funds. I would like to summarize my statement and request that the full statement be put in the record.

Senator ARMSTRONG. We would be delighted to.

Mr. MYERS. As you know, at present I am Executive Director of the National Commission on Social Security Reform, but I am appearing solely in my personal capacity. Accordingly, any views which I express are not necessarily those of the National Commission.

The interest income of the social security program is not a major factor in its financing, but neither is it of negligible importance. In 1981, the interest income of the four funds was only 2.15 percent of total income. However, such interest income was the not insignificant sum of $4.16 billion, which incidentally was 1.4 times as large as the administrative expenses.

Since mid-1940, the payroll taxes have been automatically appropriated to the trust funds as received by the Treasury. They were never spent for other purposes at any time, under any administration—as one occasionally hears.

The investments can be either in special issues or in other Federal securities. Despite what is occasionally said, at no time have moneys been loaned from the trust funds—either without interest or at interest—-to finance other governmental activities. The vast majority of the investments have been in special issues. As of mid-1981, 92 percent of the assets were in special issues.

Although at times there has been considerable opposition to investing the funds in Government bonds, no convincing support has been offered for any other form of investment. One possibility would be securities of private concerns. The objection to this is that the Government would control a considerable portion of the private industrial economy.

In light of current high interest rates, there has been criticism of the investment results of the trust funds. For example, it has been pointed out that, during the year ending June 30, 1981, the effective annual rate of interest earned by the OASDI trust funds was only 9.2 percent, whereas private money-market managers currently earn about 13 percent.

This is not a valid comparison. It contrasts the investment return of a portfolio of securities purchased over a long period of years with the current, relatively high rate on new issues. The securities bought in the past bore interest rates which were proper and equitable then.

The high interest rates quoted for private money managers are those obtained for securities purchased currently. Any private investment organization which has built up a portfolio over the years in a prudent manner would currently have a much lower average rate of investment return for its total portfolio than it would for securities bought currently—just as is the case with the trust funds.

An insurance company or pension fund founded this year would have a much higher average rate of return than a similar organization which began operations years ago and holds many securities purchased over the years. The investment rate of return of the OASDI trust funds compares favorably with that of life insurance companies. In 1980, the average rate for the trust funds was 8.8 percent. In contrast, the net rate of investment income of all U.S. life insurance companies in 1980 was 8 percent.

The criticism has, at times, been made that the trust funds should be invested in short-term Government obligations, rather than long-term ones. It would have been feasible for these investments to have been in short-term obligations, rolled over every year. At present, this would have the advantage of the high short-term rates. In hindsight—just as with other investment experience—this would have been more advantageous.

The general past experience has been that long-term interest rates are somewhat higher than short term ones. Accordingly, over the long run the long-term interest rate procedure would seem preferable. Furthermore, the current high interest rates are unlikely to last much longer. A change now to short-term securities would not be nearly as advantageous as continuing the present procedure, under which large amounts of long-term investments are locked in at about 13 percent interest.

Another investment strategy is to permit the trust funds to roll over their assets into securities with the highest current yield, but only when such yield exceeds that of the particular current holdings. This would be advantageous to social security, but it would be inequitable to the General Treasury. Private investors are not given this best of both worlds possibility, but rather when they dispose of securities with a coupon interest rate lower than current market rates, they must sell on the open market at less than par.

Some have proposed that, on a one-time-only basis, the portfolio of the funds should be redeemed at par, and the proceeds invested at current high rates. This special treatment for the funds does not seem warranted.

Under actual past experience, the trust funds already have a big advantage not available to other investors—namely, that when special issues must be sold to meet current outgo, they are redeemed at par far in advance of their scheduled maturity date. However, the opposite situation would occur if market interest rates drop sharply, and high-interest special issues are redeemed at par.

It might be required that all investments should be in marketable securities. This procedure would have the disadvantage of possible disruption of the Government bond market.

Perhaps the most important change would be the general instruction to the managing trustee to make investments in a manner so as to secure the maximum possible interest yield, commensurate with safety—although continuing investment in Government obligations. Such discretionary action should not be made available, because of the possibilities of investment loss and political and fiscal manipulation. Instead, the investment procedure should be automatic and equitable to all parties concerned.

Another important change in the bill is to base the interest rate for new special issues on the average market yield of all outstanding Government obligations rather than, as now, only on those with at least 4 years until the earliest possible maturity. Under current conditions, this would result in higher interest rates on new special issues. However, it is likely that, over the long run, the present interest-rate basis would provide more advantageous results for the trust funds.

The bill also proposes to enlarge the Boards of Trustees by including four individuals from outside of Government service. It would be desirable to have public members as trustees, if for no reason other than the public relations aspects. However, a different composition than in the bill would be desirable. I propose that there be six outside members—two named by the Senate, two by the House, and two by the President, with no more than one of each of the three pairs being of the same political party.

My general recommendations: On the whole, the investment procedures for the trust funds followed in recent years have been proper and correct. However, several changes would be improvements. First, the law should state specifically how the durations of new special issues should be determined.

The present procedure is appropriate, but should be formalized by being in the law. Thus, the managing trustee could not arbitrarily change the investment procedure for special issues as to their durations. This would then eliminate one aspect of the problem of the Secretary of the Treasury wearing two hats.

Second, the little-used possibility of investing in other than special issues should be eliminated. This would remove one area of discretion and possible conflict of interest on the part of the Managing Trustee.

The present investment policies and procedures for the trust funds is proper and equitable to both these funds and to the General Fund of the Treasury. Likewise, both the insured persons under social security and the general taxpayers—who, by and large, are the same persons—are treated in a fair, equitable, and consistent manner.

The rates of return obtained currently are reasonable in light of the past investment experience. The appropriate investment procedure is to choose one policy and remain with it, rather than attempting to do better by jumping back and forth among investment strategies. The confidence of the American public in the financial soundness of social security is not likely to be improved by switching to a basis under which whatever new political administration is in power can make changes in the investment strategy and decisions. Thank you, Mr. Chairman.

[The prepared statement of Mr. Myers follows:]

STATEMENT ON THE INVESTMENT OF THE SOCIAL SECURITY TRUST FUNDS BY ROBERT J. MYERS

Mr. Chairman and Members of the Committee:

I am pleased to be here today to discuss the investment policy of the four Social Security trust funds -- the Old-Age and Survivors Insurance Trust Fund, the Disability Insurance Trust Fund, the Hospital Insurance Trust Fund, and the Supplementary Medical Insurance Trust Fund. At present, I am Executive Director of the National Commission on Social Security Reform, but I am appearing here solely in my personal capacity. Accordingly, any views which I express are not necessarily those of the National Commission on Social Security Reform.

The investment of the assets of these funds is, by law, the responsibility of the Secretary of the Treasury, as Managing Trustee of the several Boards of Trustees. During my many years of association with the program, both when employed by the Social Security Administration and at other times, I have studied the subject with considerable diligence.

Although the interest income of the Social Security program is not a major factor in its financing -- whereas, in funded private pension plans, investment income is a very significant element -- neither is it of negligible importance. For example, in calendar year 1981, the interest income of the four trust funds was only 2.15 percent of the total income. However, such interest income was the not insignificant sum of $4.16 billion, which incidentally was 1.4 times as large as the administrative expenses of the program.

Investment Procedures

Throughout the entire period of operation of the program, the method of investing the assets of the trust funds has changed relatively little. In general, it may be said that the trust funds receive the payroll taxes and such other income as enrollee premiums for Medicare and matching payments from the General Fund of the Treasury and pay out the benefits and administrative expenses. The excess of the income over the outgo is invested in obligations of the Federal Government, and the interest therefrom augments the income of the system.

Since the middle of 1940, the Social Security payroll-tax collections have been automatically appropriated to the trust funds as they are received by the Treasury Department, and they were never spent for other purposes at any time, under any Administration -- as one occasionally hears.. Before then, a somewhat different procedure was followed, which gave about the same final result. The authorized appropriations to the Old-Age Reserve Account (as it was called then) were not specifically measured by the taxes collected, but rather were to be "an amount to be determined on a reserve basis in accordance with accepted actuarial principles." Underlying legal and constitutional aspects made a distinct division between the taxes collected and the benefits paid seem desirable. In actual practice, however, this language was interpreted to mean that the appropriations should be the estimated net proceeds of the taxes, after deduction for the estimated administrative expenses (which procedurally were paid out of the General

Fund of the Treasury, but in practice came from the gross Social Security payroll tax receipts).

After the program was declared to be clearly constitutional in 1937, this indirect procedure was no longer necessary. As a result, the 1939 Act provided for the current automatic-appropriation basis.

The investments of the trust funds can be either in special issues or in any other securities of the Federal Government. Despite what is occasionally said, at no time have monies been loaned from the trust funds -- either without interest or at interest -- to finance other governmental activities. Some regular issues have, in actual practice, been bought -- both on the open market and when they were offered to the general public. Special legislation has provided that certain semi-government issues -- such as those of the Government National Mortgage Association -- can be purchased by the trust funds, even though they are not guaranteed for both principal and interest by the Government.

The vast majority of the investments, however, have been in special issues. As of June 30, 1981, about 92 percent of the assets of the four trust funds were in special issues (see Attachment A).

Before 1940, it was provided that the special issues should bear an interest rate of 3 percent. From then until the 1956 Act, they carried an interest rate slightly below the average coupon rate on all interest-bearing obligations of the United States outstanding at the end of the month preceding the issue of the special issues.

The 1956 Act changed the interest basis for special issues so that it was determined from the average coupon rate on all long-term Government obligations (issued initially for 5 or more years), rounded to the nearest 1/8 percent. The 1960 Act revised this interest basis, so that the interest rate is now determined from the average market yield rate on Government obligations that are not due or callable for at least 4 years from the date of determination. The actual experience over the years as to the interest rates applicable to special issues and as to the durations until their maturity is described in Attachment B.

Alternative Possible Investment Areas

Although, at times, there has been considerable opposition to investing the excess income of the system in Government bonds, no convincing support has been offered for any other form of investment. All other possibilities have seemed to be objectionable for overwhelming reasons.

One possible investment practice would be to purchase securities of private concerns, either bonds or stocks. There are several objections to this approach. First, with the large amount of money available, the Government would control a considerable portion of the private industrial economy, which would, in effect, result in "socialism by the backdoor method."

Another practical disadvantage would be the need for a far-reaching and deep-searching investment policy that would permit the trust funds to obtain an adequate rate of investment return, with reasonable security of the investment principal. Under such a policy, the Government would, in effect, be setting itself up as a rating organization, because the investment procedures would naturally have to be open to full public view. If preferences were not shown as among different types of securities, but rather investments were made widely and indiscriminately, there would be a serious danger of loss of principal and diminution of investment income.

Another possible procedure would be to invest the funds in social and economic activities such as the construction of housing, dams, hospitals, and the like (as is done in some countries). This method would be open, in part, to objection on the grounds mentioned previously -- Government entry into private fields of activity. Even more serious is the argument that any use of public funds for such purposes should be under the control of the elected representatives of the people (Congress), rather than having the indirect, less visible, approach of having a social insurance organization making decisions as to what is best for the country. In addition, such investment procedure might result in lower rates of investment return and possible losses of principal, which the beneficiaries would feel to be imprudent use of their funds.

Accordingly, it may properly be concluded that investment of the assets of the Social Security trust funds can feasibly be made only in securities of the Federal Government.

Criticisms of Trust-Fund Investment Results

In the light of current high interest rates, there has been criticism of the investment results of the Social Security trust funds. For example, it has been pointed out that, during the 12-month period ending June 30, 1980, the effective annual rate of interest earned by the combined investments of the OASI and DI Trust Funds, including securities acquired many years ago, was only 8.4 percent, whereas private money-market managers currently earn about 13 percent. (For the year ended June 30, 1981, the rate earned by these trust funds on its total portfolio has risen to 9.2 percent.)

This is not a valid comparison, because it contrasts (a) the investment return of a portfolio of securities purchased over a long period of years with (b) the current, relatively high rate on new issues. The securities bought by the trust funds in the past bore interest rates which were proper and equitable at the time of purchase.

In this connection, the high interest rates quoted for private money managers are those obtained for securities purchased currently.

Any private investment organization which has built up a portfolio over the years (and has done so in a prudent manner) would currently have a much lower average rate of investment return for its total portfolio than it would for securities bought currently -- just as is the case with the Social Security trust funds. As another example, an insurance company or pension fund which was founded this year would have a much higher average rate of investment return than a similar organization which began operations many years ago and had, in its investment portfolio, many securities which were purchased years ago when interest rates were lower.

Thus, comparing current investment managers, one should not simply measure the average rate of return on their total portfolios -- which may have been acquired with much different timing -- but rather one should take into account other factors -- e.g., the experience as to current investments. In that regard, the Social Security trust funds have been obtaining relatively high interest rates on their current investments. For example, the interest rate on special issues acquired in June 1981 was 13 percent, and it was at this rate that some $20 billion of new issues were acquired on June 30, with maturities of up to 15 years.

Moreover, as securities which were purchased many years ago mature, and as new higher-interest securities are purchased, the average effective rate of return for the assets of the trust funds will rise.

Attachment C shows the effective rates of investment return for the trust funds for various years in the past, for each fund separately. It is significant to note that, despite each of the trust funds receiving exactly the same rate on special issues purchased at a given time, the average effective rates for various years differ significantly among the trust funds. This is, of course, due to the different times of purchases of the various securities held.

Also, it is of significance to compare the investment rate of return of the OASDI Trust Funds with that of life insurance companies in the aggregate. In the 12-month periods ending June 30, 1980 and June 30, 1981, the average rates for the trust funds were 8.4 percent and 9.2 percent, respectively, or an average of 8.8 percent. In contrast, the net rate of investment income (before Federal income taxes) of all United States life insurance companies in calendar year 1980 was 8.0 percent (source: "1981 Life Insurance Fact Book", American Council of Life Insurance, page 61). Thus, the trust funds had an investment experience closely comparable with that of life insurance companies in the aggregate.

A life insurance company which was formed in 1980 would, of course, have had a much higher rate of return, because it would be holding only new investments, which would be at a relatively high rate. This, however, would not "prove" that it was an extremely sagacious investor, or on the contrary that the older, well-established companies were stupid investors.

Criticism of Duration of Investments

Finally, the criticism has, at times, been levied that the Social Security trust funds should be invested in short-term Government obligations, rather than long-term ones. It would have been feasible for these investments to have been in short-term obligations, which would be rolled over every year, instead of in long-term obligations, generally having a maturity length of 15 years. At the present time, this procedure would have the advantage of the high current short-term interest rates. In hindsight -- just as with other investment experience -- this might have been more advantageous if it had been done in the past.

The general past experience has been that long-term interest rates are somewhat higher than short-term ones -- even though this is not so at the moment. Accordingly, over the long run, the long-term-interest-rate procedure would seem preferable. Attachment D compares the average market-yield rate of all obligations of the U.S. Government with the corresponding long-term rate that the trust funds receive on new special issues. For 1967-81, the interest-rate basis used for Social Security trust-fund investments was higher than the all-obligations rate in 9 years (with 1 year being the same). The average excess was .35 percentage points.

Furthermore, the current high interest rates of about 13 percent are unlikely to last for much longer. With interest rates lower in the years ahead, a change now to short-term securities would not be nearly as advantageous as continuing the present procedure, under which very large amounts of long-term investments are "locked in" at about 13 percent interest.

Another investment strategy which is occasionally proposed is that the Social Security trust funds should be permitted to roll over their assets into securities with the highest current yield, but only when such yield exceeds that of the particular current holdings. Such a strategy would be very advantageous to the Social Security system, but it would be very disadvantageous -- and, in fact, inequitable -- to the General Treasury, which would have to pay the higher amounts of interest due from general revenues. Thus, while the Social Security trust funds would do better with such a strategy, the additional interest earnings would ultimately be reflected in higher Federal income taxes or a larger Federal deficit. In other words, it would be an indirect form of general-revenue financing for Social Security. Then, too, private investors are not given this "best of both worlds" possibility, but rather when they wish to dispose of securities which have a coupon interest rate which is lower than current market rates, they must sell the securities on the open market at less than the par or face amount.

At times, some individuals propose that the law be changed so that, on a one-time-only basis, the portfolio of the trust funds should be rolled over -- i.e., redeemed at par -- and the proceeds invested at current high interest rates. Again, this special treatment for the trust funds does not seem warranted. Other investors cannot obtain this windfall advantage.

Under the actual past experience, the trust funds already have a big advantage, which is not available to other investors -- namely, that when special issues must be sold to meet current outgo, they are redeemed far in advance of their scheduled maturity dates, even though their low coupon rates would mean that, if sold on the open market, they would be priced well below par. Of course, the opposite situation would prevail if market interest rates were to drop sharply, and high-interest special issues were redeemed at par -- as against their much higher "value" if they were marketable and were sold on the open market.

One possible change that could be made to assure that the Social Security trust funds are equitably treated from an investment standpoint would be to require that all investments should be in marketable securities, either purchased on the open market or when publicly issued. This procedure, however, would have the disadvantages of possible disruption of the government-bond market because of large purchases and the choices available to the Secretary of the Treasury as to which issues to purchase (e.g., short-term versus long-term ones).

Evaluation of S. 1528

S. 1528, introduced by Senator Proxmire on July 29, 1981, would make several changes affecting the investment operations of the Social Security trust funds.

Perhaps the most important change would be the introduction of the broad, general instruction to the Managing Trustee (the Secretary of the Treasury) to make investments in a manner "so as to secure the maximum possible interest yield, commensurate with safety" -- although continuing to require investment in Government obligations, in obligations guaranteed as to principal and interest by the Government, and in investments of federally-sponsored agencies that are authorized for trust-fund investment purposes. In my opinion, such discretionary action should not be made available to the Managing Trustees, because of the possibilities of investment loss and political and fiscal manipulation. Instead, the investment procedure should be automatic, non-discretionary, and equitable to all parties concerned.

Another important change is to base the interest rate for new special issues on the average market yield of all outstanding Government obligations -- rather than, as at present, only on those with at least 4 years to go until the earliest possible maturity or call date. Under current market conditions, this would probably result in somewhat higher interest rates on new special issues. However, as indicated previously, it is likely that, over the long run, the present interest-rate basis would provide more advantageous results for the trust funds. Accordingly, I do not favor such a change.

The bill also proposes to enlarge the membership of the Boards of Trustees by including four individuals from outside of Government service -- a representative of employers, a representative of employees, a representative of the beneficiaries, and an investment expert. In my opinion, it would be desirable to have public members on the Boards of Trustees -- if for no reason other than the public-relations aspects. However, I believe that a different composition would be desirable. I propose that there should be six outside members -- two named by the Senate, two named by the House of Representatives, and two named by the President (of whom at least one would be an investment expert), with no more than one of each of the three pairs of named persons being of the same political party. The main reason for my proposal is to have the broadest possible constitution of the membership, on a bipartisan basis with the input of the Congress.

My Recommendations

I believe that, on the whole, the investment procedures for the trust funds which have been followed in recent years have been proper and correct. However, I think that several changes would be improvements.

First, and most importantly, the law should state specifically and precisely how the durations of new special issues should be determined. The present procedure, as described earlier, is quite appropriate, but I believe that it should be formalized by being in the law. Thus, under these circumstances, it would not be possible for the Managing Trustee to arbitrarily change the investment procedure for special issues as to their durations -- just as, under present law, the interest basis is not subject to change at will. This procedure would then completely eliminate one aspect of the problem of the Secretary of the Treasury "wearing two hats".

Second, the possibility of investing in other than special issues should be eliminated, both because it has been so little used in the past and for other reasons. As a matter of fact, the last time that any investment in other than special issues occurred was in fiscal year 1969, not counting instances where a public-issue bond matured and was replaced by another such bond which was made available first to those holding the matured bond. The utilization of only special issues as the investment media for the trust funds quite properly removes one area of discretion and possible conflict of interest on the part of the Managing Trustee.

Third, public members should be added to the Boards of Trustees -- in the manner recommended previously in my testimony.

Summary and Conclusions

The present investment policies and procedures for the Social Security trust funds is proper and equitable to both these funds and to the General Fund of the Treasury. Likewise, both the insured persons under Social Security and the general taxpayers -- who are, by and large, the same persons -- are treated in a fair, equitable, and consistent manner.

The rates of return obtained by the trust funds currently are reasonable in light of the past investment experience. The appropriate investment procedure, in my view, is to choose one investment policy and remain with it, rather than attempting to do better by speculating through jumping back and forth among investment strategies. In my opinion, the confidence of the American public in the financial soundness of the Social Security program, and particularly as to the management of the trust funds, is not likely to be improved by switching to a basis under which whatever new political administration is in power will make changes in the investment strategy and decisions.

Attachment A

DISTRIBUTION OF ASSETS OF SOCIAL SECURITY TRUST FUNDS, BY TYPE, JUNE 30, 1981

(in millions)

Category	OASI	DI	HI	SMI	Total
Special Issues	$23,393	$3,569	$17,659	$3,791	$48,412
Marketable Securities a/	1,996	295	---	---	2,291
Participation Certificates	555	---	50	---	605
Undisbursed Balances	1,203	19	-110	9	1,121
Total Assets	27,147	3,884	17,599	3,800	52,430

a/ U.S. Treasury securities only (participation certificates of the Government National Mortgage Association are also marketable, but are not included here).

Attachment B

INTEREST RATES AND DURATIONS UNTIL MATURITY OF SPECIAL ISSUES OF INVESTMENTS OF SOCIAL SECURITY TRUST FUNDS

In 1940-43, the new special issues were for durations of four or five years. Beginning in 1944, some new special issues were for durations of one year (or less); beginning in 1945, all new special issues were of this duration. Accordingly, beginning in 1947, the entire investment portfolio was reinvested each year (on June 30). This procedure was followed until 1957, when a transition was begun toward spreading the investment portfolio of each of the trust funds over the following 10 years. Investments during a fiscal year were made in certificates that mature at the end of such year — June 30. At that time, the funds from the maturities were reinvested in long-term notes (up to seven years until maturity) or bonds (of seven years or more).

Then, in 1959, the permanent portfolio of special issues was spread more or less equally over the next 15 years, and this principle was followed until the late 1960s. In order to be equitable to the trust funds as interest rates rose above 4 1/4 percent, then, this principle was suspended, and new special issues were given a maturity of seven years, because other provisions of law prohibited a higher rate than 4 1/4 percent for longer-term securities. Such prohibition was removed insofar as the trust funds are concerned in mid-1974. Then blocks of special issues at an interest rate of 7 5/8 percent were purchased with the funds then available for investment, in equal amounts maturing in each year of 1981-89. Since then the "equal spreading over 15 years" principle has been followed.

The special-issue interest rate was initially 2 1/2 percent (in 1940), but as large volumes of long-term government bonds were floated to finance the war effort, the rate gradually decreased and reached a low of 1 7/8 percent in the period from May 1943 to July 1946. Thereafter, there was a gradual rise to 2 5/8 percent for the period from July 1958 to September 1960, which was the last month before the new basis provided by the 1960 Act went into effect.

When the interest basis was changed by the 1956 Act (effective for October 1956), there was no change in the rate actually made available to the trust funds. As it happened, under the conditions prevailing at that time, the new method of basing the rate on long-term obligations (rather than on all obligations) produced a slightly lower unrounded rate, but the change in the rounding procedure produced a final result that was exactly the same as the previous basis.

The new basis under the 1960 Act produced a sharp increase in the special-issue interest rate, yielding rates of 3 7/8 to 4 percent for issues purchased in the last three months of 1960, or appreciably in excess of the 2 3/4 percent rate that would have been in effect then under the old basis. During 1961-65, this interest rate was generally between 3 3/4 and 4 1/4 percent, but thereafter it rose significantly, reaching a high of 7 7/8 percent in February 1970. Then the rate fell somewhat and was about 6 percent during 1971-72, but rose to about 6 3/4 percent during 1973. Then it increased further in 1974, reaching a peak of 8 1/8 percent in September, but fell off to about 7 to 7 1/2 percent thereafter through 1977. In 1978, the rate increased to as much as 8 7/8 percent and was as high as 10 1/2 percent in late 1979. It then increased sharply in early 1980, peaking at 12 3/8 percent in March, then fell to 9 3/4 percent in June, and thereafter rose to 12 1/8 percent in December. Then, in 1981, the rate had a rising trend and was 13 percent in June, 13 1/4 percent in July, 14 percent in August, and 14 7/8 percent in September.

Attachment C

EFFECTIVE RATES OF RETURN FOR SOCIAL SECURITY TRUST FUNDS IN VARIOUS YEARS

12-Month Period Ending on June 30	OASI	DI	OASI-DI	HI	SMI
1961	2.7%	2.7%	2.7%	a/	a/
1962	2.8	2.9	2.8	a/	a/
1963	2.9	3.0	2.9	a/	a/
1964	3.0	3.1	3.0	a/	a/
1965	3.1	3.2	3.2	a/	a/
1966	3.3	3.6	3.3	a/	a/
1967	3.6	3.9	3.6	4.6%	4.6%
1968	3.9	4.2	3.9	4.9	4.8
1969	4.1	4.8	4.2	5.3	5.2
1970	4.7	5.6	4.8	6.0	5.9
1971	5.2	6.1	5.3	6.5	6.4
1972	5.3	6.1	5.4	6.7	6.2
1973	5.5	6.1	5.6	6.4	6.1
1974	5.9	6.4	6.1	6.7	6.8
1975	6.5	6.8	6.5	7.2	7.1
1976	6.8	6.8	6.8	7.2	7.2
1977	6.9	7.0	6.9	7.3	7.4
1978	7.2	7.4	7.2	7.4	7.4
1979	7.4	7.9	7.4	7.7	8.2
1980	8.3	8.8	8.4	8.2	8.3
1981	b/	b/	8.8	8.9	8.7

a/ Trust fund began operation in 1966.

b/ Rate not computed because of distortion caused by reallocation of OASDI tax rate between OASI and DI during year.

Attachment D

AVERAGE MARKET-YIELD RATE ON MARKETABLE INTEREST-BEARING OBLIGATIONS OF THE UNITED STATES, AS OF THE BEGINNING OF JUNE OF VARIOUS YEAR

Year	All Obligations	Trust-Funds Special-Issue Rate for June [1]	Difference
1981	14 7/8%	13%	1 7/8%
1980	8 7/8	9 3/4	-7/8
1979	9 1/2	8 3/4	3/4
1978	7 3/4	8 1/4	-1/2
1977	6	7 1/8	-1 1/8
1976	6 5/8	7 1/2	-7/8
1975	6 1/4	7 3/8	-1 1/8
1974	8 3/8	7 5/8	3/4
1973	6 7/8	6 5/8	1/4
1972	4 5/8	5 3/4	-7/8
1971	5 1/4	6 1/8	-7/8
1970	5 1/2	7 5/8	-2 1/8
1969	6 1/2	6 1/2	---
1968	5 3/4	5 5/8	1/8
1967	4 1/8	4 3/4	-5/8

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[1] Average market-yield rate of U.S. marketable obligations with 4 or more years until maturity.

Senator **Armstrong**. Thank you, Mr. Myers.

Senator Proxmire.

Senator **Proxmire**. Thank you very much, Mr. Chairman.

Mr. Myers, you indicated that life insurance companies have an even poorer record than the social security trust fund. They had a yield of 8 percent compared to 8.2 percent or something like that during a comparable period. Is it not true that one of the reasons is because life insurance companies invest in common stocks and under law the social security trust fund has to invest in Treasury securities and that by and large Treasury securities have had a far better yield, a better return, than common stocks have had?

Mr. **Myers**. Senator Proxmire, what you say is part of the reason, although I am sure you know, life insurance companies have relatively low limits as to the proportion of their assets which they can put in common stocks. Other reasons are the difference in timing of the investments. The investments of the life insurance companies included many investments that we bought back in the 1930's and 1940's, probably to a greater extent than the social security trust funds.

Really, to make a proper analysis you would have to look at the duration. So, I was not saying that the life insurance companies operated poorly. I was just saying their rate of return is in the same ball park as the experience of the trust funds.

Senator **Proxmire**. Well, I think you make a very valid point, that if you invest over a period of time and you have rising interest rates, obviously if you compare the yield at present with the people who have invested over time then the yield will be lower for those who have to invest, as the life insurance companies have and as the social security has.

What I am saying in the amended bill—you did not have a chance to see that—is that investment decisions would be automatic. It would not rely on the investment judgment of a group, so you would not have to appoint people with so-called no conflict of interest. It would be automatic and it would get the same yield as the Treasury securities provide for market investors. Technically we would take out those that have a deep discount.

But does that improve the bill, in your judgment?

Mr. **Myers**. Yes. I am very glad you asked me that, because I was very interested in the presentation of your revised plan. I think that, although I would prefer the present basis, the approach that you have suggested is an acceptable and an equitable one.

The only problem that I would see with it—and I do not think that it is a serious problem—is that the investment rate of return could fluctuate up and down rather significantly, depending on the general level of interest rates.

Senator **Proxmire**. Well, wouldn't that be an advantage in a sense, inasmuch as it is not certainly, as we know right now, always the case? But in general interest rates rise with the rise of inflation and, of course, the payment of the CPI adjustment represents in particular a peculiarly difficult drain on the social security fund.

Mr. **Myers**. Yes. I think you have a very good point and a very good argument there. I think the only other things that I would suggest about your plan are perhaps more technical.

I like your idea of having the average interest rate being determined by being spread out over the month, and I think the Treasury Department official also said that. I would, however, determine the rate retrospectively. In other words, for a given month, I would use the average balance and have applied to that the average interest rate in the previous month, which was already known at the beginning of the month.

The other thing I would do, although I am not clear what your position on this was, is that I would keep the existing portfolio as it is and just let it be liquidated as the maturity schedules provide. Then, I would put all new investments into this type of savings account that you suggest. Incidentally, I do not agree with how the Treasury Department representative—Mr. Stalnecker—described this basis—as a short term account.

I do not agree with him at all that using the average market rate on all obligations, as you propose, would not be proper. I think that is perfectly appropriate because the proposed account is not necessarily a short term one. It is just an account.

Senator PROXMIRE. Just as a matter of curiosity, why do you think it is proper for the funds to invest in a 15-year bond when the bond can be redeemed at any time at par? Isn't that a contradiction and are now the terms really investing in short term deposits?

Mr. MYERS. I think that, considering the nature of the system, this feature of redeeming at par is a proper one. I think that the problems with it that you point out are avoidable by adopting the approach you have of a savings account basis that is neither a short term nor a long term one, but rather one that just participates equitably in the interest returns that all investors get at that time.

Senator PROXMIRE. Director Rivlin, I just have one question for you, and I thank you very much for your statement.

You say in your summary that the savings account approach appears attractive. Mr. Myers has indicated, and others indicate, that we ought to stick with what we have, that we should not move back and forth. And I think all of us agree that it would be good to have a stable policy.

How do you answer that? Of course, I feel that we ought to change, as you know, but how do you answer the view that we should not change? We are now at a period of very, very high interest rates, based on historical experience. It may be that interest rates will fall, in which case the social security fund would be better served by pursuing the present policy.

Ms. RIVLIN. I do not think there is any right or wrong way to do this. You can argue it both ways. One advantage of the savings account type of approach does seem to me to be that it is very simple and it is understandable to people. You would need a rule for getting interest rates—for example, a composite rate or a short term rate—to retain the advantage of simplicity.

On the other hand, it should be recognized that it is likely that interest rates will come down over time and that the savings account approach would provide less income to the fund than the current practice. On the other hand, if you redeem the securities now you would have a short-run gain.

There is no single right way to do this from the budget point of view. The thing to keep in mind is that we should not change too often. But, you know, once every 20 years is not too bad. The other important thing about the budgetary picture is not to forget that whatever you do here it is not clear how it will work out exactly in the long run but it is not going to make a big difference in the balances of the fund.

Senator PROXMIRE. Well, especially that last point. You are an economist and don't you recognize that one of the most difficult things is to predict what is going to happen? People are always asking me—I am sure they are asking you—are interest rates going up or down. Who knows?

We cannot tell. Historically they seem very high. You indicated that perhaps they will start going down. We cannot predict it. Therefore, it does not seem sensible to follow a policy which is as automatic as possible and reflects the actual return that the fund provides for private investors.

Ms. RIVLIN. Yes; and that is why I am attracted to the savings account approach.

Senator PROXMIRE. Thank you. Thank you very much, Mr. Chairman.

Senator ARMSTRONG. Dr. Rivlin, do you have in mind what other trust funds we might be dealing with other than those in the social security system? It appears to me that if we make a change such as has been suggested either by Senator Proxmire or Senator Stennis and the other proposals that have been advanced that we would very likely want to address ourselves to other trust funds.

Do you know offhand how many other such trust fund possibilities there are?

Ms. RIVLIN. Not offhand. There are several.

Senator ARMSTRONG. Do you have staff that could write us a memo on this?

Ms. RIVLIN. Yes; we can certainly produce a memo on that—the number and the funds involved.

[The information follows:]

CONGRESSIONAL BUDGET OFFICE
U.S. CONGRESS
WASHINGTON, D.C. 20515

Alice M. Rivlin
Director

June 25, 1982

The Honorable William L. Armstrong
Chairman
Subcommittee on Social Security and
Income Maintenance Programs
Committee on Finance
United States Senate
Washington, D.C. 20515

Dear Mr. Chairman:

In response to your request, we have prepared a brief description of the investment practices of the largest government trust funds. While there are well over one hundred trust funds, the eleven largest discussed in the attachment contain over 97 percent of all trust fund holdings of federal securities.

Should you so desire, we would be glad to provide further details.

With best wishes,

Sincerely,

Alice M. Rivlin
Director

Attachment

cc: The Honorable Daniel P. Moynihan
Ranking Minority Member

GOVERNMENT TRUST FUND INVESTMENT POLICIES

This attachment describes the investment practices of the 11 government trust funds with the largest holdings of federal securities.[1] These funds contain 97.8 percent of all federal securities held in such accounts. Trust funds with assets in the form of loans to non-federal borrowers, such as loans of the foreign military sales trust funds, are not discussed.

As of April 30, 1982, the U.S. government maintained more than 130 different trust funds with investments in government securities totaling $184.2 billion (see Table 1). More than 70 percent of the securities are held by the civil service retirement and disability (CSR) trust fund ($81.5 billion) and the four Social Security trust funds ($50.2 billion). Other trust funds with substantial holdings of government securities include the Federal Deposit Insurance Corporation ($12.7 billion), the highway trust fund ($9.3 billion), the unemployment trust fund ($9.1 billion), and the national service life insurance (NSLI) fund ($8.3 billion). The only other funds with more than one billion dollars in federal securities are the airport and airway trust fund ($4.4 billion), and the employees life insurance fund ($4.4 billion).

The investment practices of the various trust funds may be distinguished primarily by the following characteristics:

- Types of federal securities acquired;
- Method of computing interest rates; and
- Maturity structure.

Types of Federal Securities Acquired By Trust Funds

The overwhelming majority of the federal securities held by government trust funds are nonmarketable securities available only to the funds. One type of nonmarketable security is referred to as "special issues," and these securities represent the vast majority of the holdings of the CSR and Social Security trust funds. Other funds such as the FDIC generally purchase "market-based special issues".

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[1] The term "trust fund" refers to funds classified as trust funds under the federal budget account listing. Two of the 11 funds discussed in this memorandum, the Federal Deposit Insurance Corporation (FDIC) and the employees life insurance funds, are subclassified as trust revolving funds.

TABLE 1. INVESTMENTS OF GOVERNMENT TRUST FUNDS IN FEDERAL SECURITIES, AS OF APRIL 30, 1982 (In millions of dollars)[a]

Trust Fund	Amount	Percent of Total
Civil Service Retirement	81,539	44.3
Federal Old-Age and Survivors Insurance	19,891	10.8
Federal Disability Insurance	4,807	2.6
Federal Hospital Insurance	20,374	11.1
Federal Supplementary Medical Insurance	5,147	2.8
Unemployment	9,137	5.0
Airport and Airway	4,420	2.4
Highway	9,276	5.0
National Service Life Insurance	8,273	4.5
Federal Deposit Insurance Corporation	12,738	6.9
Employees Life Insurance	4,447	2.4
Other	4,133	2.2
TOTAL	184,182	100.0

SOURCE: Monthly Treasury Statement of Receipts and Outlays of the United States Government, April 30, 1982, Table IV, Schedule D, pp. 26-27.

NOTE: Components may not add to totals due to rounding.

a. Includes $765 million of agency securities such as participation certificates of the Government National Mortgage Association.

Special issues hold both advantages and disadvantages for trust funds which purchase them. The major advantage is the par redemption feature which the securities carry. This feature insulates the funds from interest rate movements that could result in capital losses if part of the portfolio had to be liquidated prior to maturity. The major disadvantage has proven to be average portfolio yields which have lagged behind the market rate during the past 20 years of rising interest rates. If interest rates had fallen, however, this lag would have resulted in average yields that exceeded market rates.

Market-based special issues are comparable to U.S. government securities purchased by the general public and can be exchanged for different market-based special issues at any time. They experience the same fluctuations in value as marketable U.S. government securities traded in the open market. Thus, the funds making these investments can benefit through capital gains when interest rates fall and suffer through capital losses when rates increase.

Table 2 displays the holdings of each of the largest funds by type of federal security. Special issues constitute about 89 percent of all investments of the Old-Age and Survivors Insurance (OASI) trust fund and 100 percent of the Hospital Insurance (HI) investments. Other funds, such as the Federal Deposit Insurance Corporation (FDIC), acquire market-based specials almost exclusively. Only a very small percentage of trust fund investments is in the form of marketable U.S. government obligations or government agency securities.

Method for Calculating Interest Rates

Interest rates on special issues are based either on market yields or on the interest rates carried by certain government obligations. Table 3 presents the bases for the interest rates on new special issues purchased by the eleven trust funds. The most common basis is the average market rate on all government securities not due or callable for four or more years. Special issues acquired by the highway, airport and airway, and unemployment trust funds, however, are assigned interest rates equal to the average interest rate on groups of outstanding government obligations.

New issues with interest rates based on market yields currently carry interest rates much higher than those based on the coupon rates of outstanding government obligations. For example, purchases of special issues by the CSR and Social Security funds

TABLE 2. INVESTMENTS IN DIFFERENT FEDERAL SECURITIES FOR THE LARGEST 11 FUNDS, AS OF APRIL 30, 1982 (In millions of dollars)

Trust Fund	Special Issues	Market-Based Special Issues	Marketable Government Issues	Agency Securities	Total
Civil Service Retirement	78,521	-	2,843	175	81,539
Federal Old-Age and Survivors Insurance	17,478	-	1,958	455	19,891
Federal Disability Insurance	4,510	-	297	-	4,807
Federal Hospital Insurance	20,374	-	-	-	20,374
Federal Supplementary Medical Insurance	5,147	-	-	-	5,147
Unemployment	8,468	-	669	-	9,137
Airport and Airway	4,420	-	-	-	4,420
Highway	9,276	-	-	-	9,276
National Service Life Insurance	8,138	-	-	135	8,273
Federal Deposit Insurance Corporation	-	12,653	85	-	12,738
Employees Life Insurance	-	3,958	489	-	4,447
Total of the Eleven Funds	156,332	16,611	6,341	765	180,049

SOURCE: Monthly Treasury Statement of Receipts and Outlays of the United States Government, April 30, 1982, Table IV, Schedule D, pp. 26-27. Monthly Statement of the Public Debt of the United States, April 30, 1982, Table III, pp. 4-15.

TABLE 3. METHOD FOR COMPUTING INTEREST RATE ON NEW SPECIAL ISSUES OR MARKET-BASED SPECIAL ISSUES

Trust Fund	Interest Rate Basis
Civil Service Retirement and Disability	Average market yield on all marketable interest-bearing U.S. obligations not due or callable until after four years.
Federal Old-Age and Survivors Insurance	Average market yield on all marketable interest-bearing U.S. obligations not due or callable until after four years.
Federal Disability Insurance	Average market yield on all marketable interest-bearing U.S. obligations not due or callable until after four years.
Federal Hospital Insurance	Average market yield on all marketable interest-bearing U.S. obligations not due or callable until after four years.
Federal Supplementary Medical Insurance	Average market yield on all marketable interest-bearing U.S. obligations not due or callable until after four years.
Unemployment	Average rate of interest borne by all interest-bearing U.S. obligations rounded to the next lower one-eighth of one percent.
Airport and Airway	Average rate of interest borne by all marketable interest-bearing U.S. obligations rounded to the next lower one-eighth of one percent.
Highway	Average rate of interest borne by all marketable interest-bearing U.S. obligations rounded to the next lower one-eighth of one percent.
National Service Life Insurance	Average market yield on all marketable interest-bearing U.S. obligations not due or callable until after three years, reduced by one-fourth of one percent, but not less than three percent.
Federal Deposit Insurance Corporation	Market yield of securities with comparable maturities.
Employees Life Insurance	Market yield of securities with comparable maturities.

during June 1982 will pay 13-1/4 percent interest, whereas those securities acquired by the unemployment trust fund in the same month carry an interest rate of 11-5/8 percent.

Maturity Structure

Government trust funds also differ in the maturity structure of their portfolios. Certain funds invest in short-term issues, others purchase securities to reflect their long-term commitments, and still others actively manage their portfolios to reflect both liquidity requirements and interest rate movements.

The unemployment, highway, and airport and airway trust funds principally invest in short-term securities, known as certificates of indebtedness. The nonmarketable federal securities of these funds mature on June 30, 1982, at which time any funds not immediately needed for program outlays will be reinvested.

Several trust funds follow a policy of purchasing new special issues so as to have roughly the same proportion of all special issues maturing in each of the next fifteen years. These funds include the CSR, Social Security, and NSLI trust funds, which together contain approximately three-quarters of all government securities held by trust funds.

Finally, the FDIC fund and the employee life insurance fund have chosen a maturity structure to reflect both the liquidity needs of the funds and interest rate movements. For example, the FDIC has adjusted the average maturity of its holdings to less than three years to ensure that the portfolio is liquid enough to protect against bank closings. Active management of these funds is facilitated by their investments in market-based special issues rather than special issues. Unlike special issues which may be redeemed at par at the discretion of the Secretary of the Treasury, transactions in market-based special issues are determined by the investing agency and implemented by the Treasury.

Senator **Armstrong**. I think that would be helpful. I gather from the discussion this afternoon that probably at some point in time we will get serious about this issue and perhaps produce a bill and it would be very helpful if we knew what other trust funds there are and the implications for those funds and for the Treasury of whatever changes we take into account.

I would also ask—and I am not sure, doctor, whether this is well addressed to you or to Mr. Myers or perhaps to somebody over at the American Law Division. There has been some discussion this afternoon about the notion of social security as a trust fund. Indeed, they are so denominated. They are called trust funds and yet in a legal sense I think the discussion which occurred an hour or so ago was a bit misleading.

I seem to recall that there is a Supreme Court decision that makes it very clear that what we have here is a tax which is no different legally from any other tax that is levied and a program of entitlements which is not based on what you pay into it. So in any meaningful sense it is not a trust fund.

Let me just inquire. What is the best source for us to get a background memo for the benefit of the committee on the legal issues involved?

Ms. **Rivlin**. I would think maybe the General Counsel of the Social Security Administration.

Senator **Armstrong**. Mr. Myers, do you have something on the shelf that you could just furnish to us on this subject?

Mr. **Myers**. I will develop something like that for you, Mr. Chairman.

[The following was subsequently supplied:]

NATIONAL COMMISSION ON SOCIAL SECURITY REFORM
736 JACKSON PLACE, N.W.
WASHINGTON, D.C. 20503

June 25, 1982

MEMORANDUM

FROM: Robert J. Myers

SUBJECT: Request of Senator Armstrong for Additional Information

Senator Armstrong requested additional information regarding whether the four Social Security trust funds are, in fact, "trust funds" and, more particularly, regarding the nature of the beneficiaries' interest in the Social Security trust fund receipts.

Whether a trust relationship exists under Social Security is a separate question from the nature of the beneficiaries' interest in Social Security receipts. In *Flemming v. Nestor*, 363 U.S. 603 (1960), a case upholding the constitutionality of a statute terminating Social Security benefits to aliens deported for affiliation with the Communist party, the U.S. Supreme Court held that beneficiaries do not have an "accrued property right" in their Social Security benefits. Rather, it held that Congress has the authority to place limitations on, or even eliminate, Social Security benefits, provided the action is not arbitrary.

The Court based its conclusion, in part, on the clear need of Congress for flexibility to adjust to changing conditions and, in part, on a clause (which is included in the original Act and still present) which reserves to Congress "(t)he right to alter, amend, or repeal any provision" Sec.1104, 49 Stat. 648, 42 U.S.C. Sec.1304. The Court stated that the due-process clause of the Fifth Amendment of the Constitution would protect covered employees and beneficiaries from arbitrary governmental action which lacked any rational justification, but that the action contested in the *Flemming* case had a rational justification.

That Congress can place limitations on, or even eliminate, Social Security benefits does not mean that the Social Security trust funds are not "trust funds" in a legal sense. The term "trust" is a very broad concept. Thus,

> "A trust can be created for any purpose which is not illegal, which is not against public policy. The duties of the trustee are such as the creator of the trust may choose to impose; the interests of the beneficiaries are such as he may choose to confer upon them." Austin W. Scott, *Abridgement of the Law of Trusts,* (Little Brown & Co., 1960), page 3.

The principal element of a trust is the separation of legal ownership of property from equitable ownership.[1] By this test, Social Security constitutes a trust relationship.

The 1938 Advisory Council on Social Security recommended:

> "The old-age insurance fund should specifically be made a trust fund, with designated trustees acting on the behalf of the prospective beneficiaries of the program. The trust fund should be dedicated exclusively to the payment of the benefits provided under the program and, in limited part, to the costs necessary to the administration of the program."

This recommendation was enacted in the 1939 Amendments to the Social Security Act. As a consequence, Social Security receipts cannot, by law, be used for any purposes other than the payment of benefits and administrative expenses.

At the Senate Finance Committee hearing, the point was made that increased investment income will not increase the benefits of beneficiaries, but rather will only decrease the taxes of covered employees and employers. While that is true, it does not affect the status of the Social Security program as a trust arrangement. Indeed, most private defined-benefit pension plans and trusts treat investment income in precisely the same manner -- the income is used to reduce the employer liability, not to adjust benefit levels.

1/ See Ralph A. Newman, Newman on Trusts (The Foundation Press, Inc., 1955), page 3.

Robert J. Myers

June 21, 1982

MEMORANDUM

FROM: Robert J. Myers

SUBJECT: Questions Raised by Senator Boren as to Investments of Social Security Trust Funds

Senator Boren has asked two questions as to the investments of the Social Security trust funds, in connection with the hearings on this subject before the Senate Finance Committee on June 8. These questions and my answers are as follows:

Question: Do you believe the present investment form of the Social Security funds is inadequate?

Answer: In general, I believe that the present investment procedures are both adequate and equitable to all parties concerned. However, I do believe that the law should prescribe precisely how the durations of newly issued special issues should be determined, rather than letting the Treasury Department do so on the basis of the maturities being "fixed with due regard for the needs of the Trust Funds."

The present procedure, used in setting maturity dates based on "needs" is too indefinite -- and, in fact, cannot be accurately defined or administered -- and so manipulation adverse to the interest of the trust funds is readily possible. For example, when interest rates are high, new special issues might be placed in short-duration obligations, rather than spread over a 15-year period -- and vice versa.

Also, the present basis for the interest rate on new special issues might be made somewhat more equitable by eliminating from consideration in computing it the so-called "flower bonds" and bonds selling at deep discounts (which, at times, have lower market-yield rates because of the favorable tax treatment of the eventual capital gains involved). Further the trust funds should not be permitted in the future to purchase any securities other than special issues (the only purchases made in recent years).

Nonetheless, I believe that what might be termed the "savings-account" procedure, which was first proposed by Senator Proxmire at these hearings, probably has even more merit than the present procedure even if it were modified as I have suggested. However, I would propose two small changes in the Proxmire procedure. First, the present portfolio -- both special issues and marketable issues -- should not be sold in the open market or cashed in by the Treasury for any reason other than when no other monies are available to meet outgo obligations, but rather they should be held until their maturity dates. In other words, the new savings-account basis should be used only for new funds available for investment -- and should be drawn upon for outgo requirements.

Question: Do you think that it is necessary to expand the Social Security Board of Trustees in order to achieve efficiency in this investment process?

Answer: No, I do not believe that expanding the membership of the three Boards of Trustees (all three boards having the same members) is necessary to achieve better investment results, especially if -- as I recommend --the investment processes are made completely automatic, with no chance for manipulation of maturity dates. If the procedure is not made completely automatic, it might be desirable to enlarge the membership of the Boards, primarily for public-relations purposes. In fact, such enlargement is desirable in any event, for reasons that I explained in detail in my prepared statement.

Senator **Armstrong**. It would be helpful. I do not want to put you to a lot of work, but I think it is a more relevant inquiry than may at first appear, and let me develop that thought a little further.

There has been a lot of discussion here this afternoon about this trust fund idea and the desire to maximize the earnings for the benefit of those for whom the money is held in trust. And I think it is important that we keep in perspective, first, that the earnings of the trust fund or the balances of the trust fund are not in any way directly related to the benefit levels paid out, unlike a private pension or some kind of an insurance concept where how much you have got in the trust fund really determines how much you can pay out.

The benefits paid under social security are determined politically and as a matter of law rather than in any way directly, at least, related to the balances or earnings of the trust fund. It might be, and I have been sitting here thinking about this, that in some sense it is the tax rates which are more influenced by the earnings of the trust fund and so in that sense it is almost a reverse concept that really how well we perform, how well the trust funds perform from an earnings standpoint has a lot more to do with the potential level of the payroll tax than it does the benefit level, at least it has some effect, whether it is more or less, I guess, is a matter of judgment.

Mr. **Myers**. Mr. Chairman, on that point you are exactly correct. The trust-fund concept as used here solely relates to the fact that all the money that is collected goes into this fund and all the benefits and administrative expenses go out of it.

But as to the effect of more interest earnings on the fund, this relates primarily to how much additional financing might be needed. As you so correctly point out, the size of the benefits does not depend one bit on the rate of investment return, as is the case in some private pension plans or in bank accounts and similar funds.

Senator **Armstrong**. During the discussion this afternoon no one has advocated that the trust funds be directed or empowered to invest in assets other than Government securities. To your knowledge has that ever been seriously advocated by anyone?

Mr. **Myers**. I did address that in my testimony, but I eliminated it in the summarization. Over the years, occasionally, there have been people who have recommended things like that. For example, at times like the present when mortgage money was tight, there have been individuals who said that the trust funds ought to lend money for mortgages. I have not heard it currently, when mortgage money is tight, but some years ago that was done.

There has been a little of that discussion, although not anything very seriously.

Senator **Armstrong**. I take it that you do not favor that or do not regard it as a very promising avenue.

Mr. **Myers**. That is correct, as I do bring out in my prepared testimony.

Senator **Armstrong**. Dr. Rivlin.

Ms. **Rivlin**. It would seem to me that that discussion really belongs in the more basic context of how the trust fund should be financed. As long as we have the funds on a pay-as-you-go basis, while one could argue for putting the funds in the private sector, there is not very much money involved and it seems to me the counterarguments are very strong.

Those who would advocate a fully funded system so that you were building up balances now to pay for the larger cohorts coming down the line have to address this question. If we moved to a fully funded system a lot of money would be taken out of the economy and there would be strong arguments for pumping it back into the economy in some way to finance private investment. There would be enormous difficulties in so doing.

Senator ARMSTRONG. I dare say. The notion of investing social security funds in something other than Government securities is a little off the wall, particularly if you take it very far and you think about not only investing in mortgages but perhaps in common stocks, maple leaves, antiques, pork bellies, and what not.

The reason why I am leading the discussion in this direction is not quite as bizarre as the idea that we just were talking about. It is this. Suppose there were different kinds of Treasury securities than those which are presently available? To be specific, I am considering—in fact I intend—to offer an amendment when the Finance Committee marks up the debt ceiling bill, to create some different kinds of Government instruments.

It goes back to the issue of risk versus yield. Now, Mr. Myers, we were talking earlier with a representative of the Treasury about the distinction between the risk assumed by the buyer of the long-term bond and the yield he gets. Suppose, for example, we had gold-backed bonds, which is one possibility under very active consideration. The yield on those would be, presumably, 3 or 4 percent. But if backed by gold those would be very attractive instruments to some buyers under some circumstances.

The problem then becomes do you average that 4-percent yield or 3-percent yield in with the yield of all other Government securities for the purposes of computing what social security could get. Clearly I would think not, but it points out that we have got a very complicated issue. It seems to be simple on the surface, but the more deeply you get into it the more complex it becomes.

Mr. MYERS. I certainly agree with you, Mr. Chairman. As Mr. Stalnecker said, even under the present basis, there should be some technical changes to withdraw the flower bonds or any bonds selling at deep discounts from the computation of the market interest rate. Certainly, if there were the type of bonds you suggest, they should not pull down the rate that the trust funds would get on what might be called regular types of Government securities.

Senator ARMSTRONG. Well, we are very grateful to both of you for your observations and for your participation.

Dr. Rivlin, is the House going to produce a budget?

Ms. RIVLIN. I surely hope so. I think so.

Senator ARMSTRONG. Good. On that optimistic note we will stand adjourned. Thank you very much.

[Whereupon, at 4:15 p.m., the subcommittee adjourned.]

[By direction of the chairman the following communications were made a part of the hearing record:]

STATEMENT
on
SOCIAL SECURITY TRUST FUND INVESTMENT POLICY
for submission to the
SUBCOMMITTEE ON SOCIAL SECURITY AND INCOME
MAINTENANCE PROGRAMS
of the
SENATE FINANCE COMMITTEE
for the
CHAMBER OF COMMERCE OF THE UNITED STATES
by
Mark Cahoon *
June 24, 1982

The Chamber of Commerce of the U. S., on behalf of its 240,000 business and organization members, is pleased to have this opportunity to comment on Social Security trust fund investment policy.

Summary

The investment policy of the Social Security trust funds (Old-Aged and Survivors, Disability Insurance, Hospital Insurance and Supplemental Medical Insurance) is set through a combination of statutory guidelines and administrative practices. The Social Security Act sets out basic investment procedures which leave a great deal of latitude to the managers of the funds in making investment decisions. This discretion has led to the development

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*Associate Director-Retirement, Human and Community Resources Department, Chamber of Commerce of the United States of investment practices which are now being criticized as not having been in the best interests of the Social Security program. The U.S. Chamber concurs in this sentiment and would support Congressional action that addresses this problem.

Current Policy and Problems

The Social Security Act provides the following guidelines for trust fund investments:

(1) Funds not immediately needed for benefits or administrative expenses are to be invested solely in interest-bearing obligations guaranteed as to both principal and interest by the United States.

(2) The Managing Trustee (the Secretary of the Treasury) is required to invest in special public-debt obligations--special issues to the trust funds not available to the general public--except where he determines that the purchase of obligations available in the open market is "in the public interest".

(3) Obligations are to be purchased at the issue price for special issues or at the market price for marketable obligations.

(4) Special issues shall have "maturities fixed with due regard for the needs of the trust fund" and will pay a rate of interest equal to the average market yield on all marketable interest-bearing obligations of the United States which are not due or callable (redeemable) for at least 4 years.

(5) Marketable securities purchased by the trust funds may be sold at the market place and special issue obligations may be redeemed at par plus accrued interest (without penalty for redemption before maturity).

The practice that has developed is that virtually all Social Security funds are invested in special issue securities, that is, securities which can be redeemed at par at any time and whose yield is set by formula. The virtue of these securities is that they provide the Social Security system with ready sources of capital that may be redeemed at face value rather than the market rate then prevailing for regular government securities. Their drawback is that, in recent years, because of sharply rising interest rates, they have carried yields well below that available on other government securities. 97% of the funds are invested in these special issues.

Maturities of new special issues have been chosen so that approximately the same percentage of all special issue holdings will mature in each of the next 15 years. Although the Managing Trustee has authority to redeem special issue obligations at any time at par, the Treasury has followed a long standing policy of not using this option except when it has been necessary to redeem bonds to make benefit payments. Then, those issues closest to maturity are cashed in first and, if there are bonds of differing rates maturing in the same year, those with the lowest rates are redeemed first.

The policy of investing trust fund balances in relatively long-term securities has meant that, as interest rates have risen over the years, the average yield to the trust fund has lagged behind market rates.

The end result of this policy has not been good for Social Security. During the fiscal year ending June 30, 1981, the four Social Security trust funds maintained an average balance of $43 billion that was invested in Treasury securities. The funds received $3.9 billion in interest on these investments and earned an average yield of 9.1 percent. During the same period, the composite rate on all Treasury securities was 13.2 percent. Had the funds earned that composite rate, they would have received an additional $1.7 billion in interest during FY 81.

This was not an atypical year. In fact, the average yield earned by the Social Security trust funds has been below the current rate on all Treasury securities in 17 of the last 21 fiscal years. During this period, the trust funds received an average yield of 5.2% while the average market yield on all Treasury securities was 6.3%. The loss of revenue to the trust funds as a result of this difference is almost $15 billion.

Possible Solutions

Many possible solutions to this problem have been developed. Legislation has been introduced in both the House (H.R. 4382, 4443, and 4472) and Senate (S. 1528) which would make four basic changes to improve investment proceedures. The legislation would:

(1) Change the composition and size of the Social Security Board of Trustees to increase the input of those most affected by trust fund decisions as well as to increase the investment expertise and sensitivity of the Board. The Chamber is not persuaded that this change is warranted, but we are willing to support such a change if the Congress decides to enact it.

(2) Specifically charge the Trustees with the responsibility to secure the maximum yield possible commensurate with the safety of the trust funds. This may present administrative problems for the managing trustee; however, it should be pointed out that many private sector mutual funds and money market funds operate under this policy.

(3) Require that, if the Treasury continues to invest in special issues, their interest rates shall be calculated on the basis of the interest rates paid on all securities the trust funds are allowed to purchase. This appears to be an attractive alternative.

(4) Require the Trustees to modernize their equipment and seek the advice of experts that will allow them to maximize the return on investments. Clearly, this step alone will make it possible for the Managing Trustee to improve his performance.

As an alternative to these proposals, it has been suggested by Senator Proxmire in testimony before this Subcommittee on June 8 that the present system for investing in specific maturities not be modified but instead be abandoned in favor of a savings type account maintained at the Treasury. Funds could be withdrawn from this account at any time without penalty. Interest on Fund deposits in the new account would be tied to a composite rate on all Treasury securities rather than to any specific short-term or long-term rate. The composite rate would be less volatile than either short-term or long-term rates and it would better reflect the Treasury's current cost of funds.

Chamber Position

It is clear that the Social Security program is in deep financial trouble which stems from excessive benefit growth, combined with poor overall economic conditions and natural demographic changes. The interaction of these factors now threatens the very solvency of the Social Security system leaving Congress with difficult decisions on reductions in future benefit growth or tax increases. Before these decisions are made, it is appropriate for Congess to examine fully all aspects of the Social Security program and to make cost saving changes which will improve program efficiency. Trust funds investment practices is one such area.

Clearly current investment policies have not served the Social Security program well. The Social Security trust funds, receiving artificially low yields on government securities, have been subsidizing the general funds. While the primary concern in the investment of the trust funds must be the safety of the funds and access to those cash revenues by the fund managers to make benefit payments, it is also important that the funds earn the highest possible return commensurate with safety. It is not equitable for the trust funds to subsidize the general fund, just as it would not be equitable for the general fund to subsidize Social Security.

It should be further noted that current law puts the Secretary of the Treasury in the awkward position of trying to serve two competing interests. As Managing Trustee of the trust funds, his responsibility is to earn the highest possible yield on the investment of these funds while investing in government or government backed securities. As Secretary of the Treasury, his responsibility is to secure funds at the lowest possible cost. While none of the legislation filed thus far specifically addresses this situation, each of the bills would greatly reduce the amount of responsibility placed solely upon the Managing Trustee and, therefore, alleviate the situation.

Moreover, the legislation would address one of the major problems now faced by Social Security--lack of public confidence. Recent polls clearly show that American workers--especially younger workers--are losing confidence in the program. We endorse the concept of assuring that the trust funds earn an equitable return. This step will help restore confidence.

Finally, Senator Proxmire's savings account proposal presents some interesting and potentially beneficial concepts. It would remove the complexity and investment discretion which have contributed to the low yield problem and end the complicated procedures for attempting to keep maturities spread equally over 15 years. It avoids decisions over which securities to redeem whenever the Funds must make a withdrawal to meet current benefit payments. It eliminates any need to try to guess which way interest rates may be heading in the future. It guarantees that the Funds will always earn interest at a rate equal to the Treasury's current cost of money--no more and no less.

While it is clear that the trust funds investment policies present problems, there are several workable and appropriate proposals to correct them. The Chamber recognizes the need for changes in this area and urges Congress to assure that the Social Security trust funds earn a fair return.

SOCIAL SECURITY
A BLUEPRINT FOR FISCAL SOLVENCY

Wilson B. Prickett
Associate Professor of Finance
The University of Oklahoma
Norman, Oklahoma 73019

About the Author:

Professor Wilson B. Prickett has taught Business and Personal Finance at the University of Oklahoma for thirty years. He also served as Assistant and Acting Dean of his university's College of Business Administration for seventeen of those years. His activities have included business consulting, practical business experience, writing and lecturing.

Mr. Prickett's proposal for Social Security Solvency has evolved out of more than a year of study, revision and refinement of a proposal he designed in February, 1981. He then proposed phasing in a new Social Security system to replace the existing Program. Feedback from his original idea has been carefully considered in this new proposal.

Prickett did his undergraduate work in Business Administration at the University of Oklahoma, obtained his MBA at the University of Michigan in 1950 and later (1956) took additional graduate work at the University of Texas.

Mr. Prickett is also a retired U.S. Army Lt. Colonel and served with the First Infantry Division in France during World War II.

SOCIAL SECURITY
A BLUEPRINT FOR FISCAL SOLVENCY

We CAN have a solvent fiscally sound Social Security system without reducing benefits.

We CAN have 30 year, fixed-rate 9.5 percent home mortgage financing available in the billions of dollars.

We CAN restore financial stability and renewed prosperity to our thrift institutions and other mortgage lending organizations.

We CAN reduce interest rates.

We CAN reduce unemployment.

These goals are within reach without increasing our national debt or making radical changes in our present Social Security Program.

How?

By utilizing the tremendous power of compound interest available in the private sector of our economy. By creating new wealth through productive investment of a PORTION of our Social Security contributions (FICA Taxes). These dollars could be invested at 9.5 percent in home mortgages and the earnings used to provide Survivor's and Retirement benefit supplement to reduce our FICA tax burden.

This blueprint or proposal addresses the long-range fiscal solvency problem of Social Security. It does not change the structure of the present Program nor diminish benefits. In the long run, however, the FICA taxes can be lowered as a result of the supplementary financing outlined herein.

This presentation does not alter or change the Disability or Medicare Insurance Trust Funds or benefits. It presents a model which applies to the Old Age and Survivor's Trust Fund exclusively, for illustrative purposes. However, the same approach could be employed with the Disability and Medicare Trust Funds later, if it becomes necessary.

Currently, in 1982, Social Security payroll taxes are 13.4 percent of wages and salaries up to $32,400. Half of the total (6.70%) is contributed by employee and half (6.70%) by the employer. Of the total 13.4 percent, 9.15 percent is allocated to the Old Age and Survivor's Trust Fund (OASI). In this proposal all calculations are confined to just the OASI Trust Fund.

In June 1981, the OASI Trust Fund held reserves of $25.94 billion.[1] These were invested in U.S. Government securities at relatively modest interest rates.

We recommend taking $11 billion of the $25.94 billion in the OASI reserves out of government securities in year one of our model to make these $11 billion available for placement in 9.5 percent, 30 year, fixed-rate home mortgages. The placement and servicing of the mortgage money would be through existing Savings and Loan Associations, banks and other established mortgage lending institutions. The funds would be furnished at no cost to the lending institutions. These financial intermediaries would be paid one half of one percent (0.5%) for placing and servicing the home mortgages. The same credit standards should be followed as is now the case with other private investor's money in mortgage lending practices. The lending institutions would also be permitted to retain all home mortgage origination fees, as with any conventional mortgage. Monthly mortgage payments collected from the homeowners would funnel through the mortgage institutions back to the OASI Trust Fund. They would, in turn, be made available on a continuing basis to the mortgage lending institutions for reinvestment. Since the OASI Trust Fund would net 9.0 percent and the funds would consistently be reinvested, the $11 billion would be compounding at the rate of 9.0 percent. Appropriate auditing procedures could be devised to assure proper accounting for funds by the thrift institutions. The home mortgages should initially be for new construction and first-home buyers only. This formula could be modified from time to time as economic conditions warrant.

A whole series of positive effects upon our economy would result. Certainly the depressed construction and home building industry would be revitalized. Unemployment would decrease by perhaps as much as two percent. Allied industries such as lumber, furniture, carpeting, household appliances etc. would benefit, creating additional employment, as a result of the almost 200,000 new housing starts the first year alone.

Lower interest rates brought about by the influx of the 9.5 percent mortgage financing would make a great deal of small business expansion possible. If unemployment decreases by as much as two percent, the Social Security Trust Funds would gain approximately $4 billion a year through new FICA taxes being paid by the newly employed workers.[2]

Additionally, the Federal budget deficit would decrease by some $50 billion a year.[3]

Interest rates, as noted, would tend to decline in response to the injection of billions of 9.5 percent money into the home mortgage markets. Yet $11 billion a year, more or less, would not exert an undue disruptive influence upon the money markets. There would be a "portfolio" effect causing an overall decline in interest rates.[4] Such an effect would seem to be highly desirable and might well be the spark that ignites a substantial upswing in economic activity. Investment in the private sector which causes more real productivity is not inflationary.

The billions of "free money" made available to Savings and Loan Associations, banks and other existing mortgage institutions would save many of them from bankruptcy and the resultant loss of public confidence in our thrift institutions. Banks would also benefit from the new construction loan business. All thrift institutions would enjoy increased deposits and IRA accounts from many of the re-employed workers. The economy would experience a sharp boost and our young people could again realize the American dream of owning their own homes at prices they can afford. Mortgage defaults would lessen as the lower, fixed-rate mortgage structure resurfaces and replaces the alphabet soup of graduated payment home mortgages. Many of these current deferred mortgage payment plans are financial disasters waiting to happen.

As noted earlier this proposal calls for a continuing allocation of a portion of the OASI Trust Fund monies to 9.5 percent home mortgages. Starting in year one of the adoption of the proposal with $11 billion, the program will receive an additional $11 billion each succeeding year increased by 4 percent for inflation. There is a 26 year period involved, broken into two 13 year cycles.

At the end of the first thirteen year cycle, a total of $182.5 billion will have been invested in home mortgages (see Table 1, Col. 3, Year 13). Of the $182.5 billion, $181.3 billion will have been recovered by the cash flow generated by this proposed project (see Table 1, Col. 8, Year 13).

The recovery includes interest and principal plus additional FICA taxes which will accrue to the OASI Trust Fund, generated by the increased employment. While during the first thirteen year cycle, the Trust Fund Reserve will have decreased from its original $25.94 billion to $24.7 billion, there will still be about $171 billion of the $182.5 billion invested and earning 9 percent per year compounded into the indefinite future (see Table 1, Footnote 5). If this process is continued through a second thirteen year cycle, the OASI Trust Fund Reserve will have grown to $252.5 billion (see Table 2, Col. 9, Year 26). In addition, through the second thirteen year cycle another $304.5 billion will have been employed and completely recovered. The OASI Trust Fund will then, twenty-six years from the start of this proposal, have a total working capital fund of about $404 billion (see Table 2, Col. 3, Year 26, Footnote 5). This amount will be available to keep continuously invested at an assumed net of 9 percent compounded. If the $404 billion is kept continuously invested for an additional 30 years, the OASI Trust Fund would have a surplus of $5.4 trillion dollars 56 years from the day we adopt this proposal (see Table 2, Footnote 5).

That would seem to be a better future prospect than the projected $1.5 trillion dollar deficit predicted within 75 years by the 1981 Social Security Trustee's Report.[5]

As the OASI reserves continue to grow, it is obvious that FICA taxes could be reduced proportionately. An option would be to employ cash flow to reduce FICA taxes, somewhere along the line.

These results can be accomplished without altering our present Social Security System in any manner except for the temporary employment of a part of the present OASI Trust Fund Reserve. Even if it were deemed necessary to advance the funds needed for investment from the general revenues of the Federal Government, the loan could be repaid from excess cash flow within 12 years (see Table 3, Col. 7, Year 12). This would result from the net gain to the OASI Trust Fund from interest return on investment plus the additional FICA taxes generated by the assumed 2 percent increase in employment. These additional FICA taxes are estimated to be $4 billion a year, as noted earlier. Even if the Treasury had to borrow the "start-up" money in year one the plan is feasible (see Table 3). If unemployment declined by 2 percent, the Federal deficit would decrease by $50 billion so the Treasury would gain about $24 billion in the process.[3]

What are the alternatives to the approach recommended by this proposal?

Long-range alternatives are bankruptcy of our Social Security System; increased FICA taxes; increased Federal debt or drastically reduced benefits. This proposal, which can be modified upwards or downwards, offers at least a base upon which to build. It presents a practical approach to the immediate solution of several of our most pressing national economic problems.

More importantly, the growing OASI reserves made possible by productive employment of a portion of the FICA taxes in the private sector of the economy will move the Social Security Program toward fiscal solvency. Within a few years FICA taxes could be substantially reduced to within bearable limits as the OASI reserves grow in size.

One might ask what happens if interest rates eventually fall below 9.5 percent? OASI Fund investment rates for home mortgages could be pegged at, say 65-70 percent of the prime rate or going conventional mortgage rates. Changes could be made by the appropriate Social Security governing body as required by economic conditions, perhaps every year or so.

By pegging the required interest return at some percentage below going rates there would consistently be a kind of wholesome restraint on interest rates. Explosive interest rates which price our young people out of the housing market would not occur again, nor would our thrift institutions be driven to the edge of bankruptcy to the detriment of all of us. If interest rates declined over the coming years, a dollar averaging effect upon the OASI Trust Fund would occur. The calculations presented in this proposal's illustrations would change in scale. The principles would not change. If we experienced a prolonged deflationary period, beneficiaries would not require as much retirement or survivor's income. That would be particularly true if many more millions of Americans own their own homes.

Should interest rates rise, the ever increasing OASI reserves would provide for cost of living increases.

In the calculations presented for illustrative purposes in this paper, an automatic 4 percent inflationary factor has been built-in as a basic assumption.

The proposal suggests a kind of Social Security mutual fund by and for the people. The citizen's retirement contributions, a portion of which are invested in home mortgages, would make it possible for many more millions of Americans to own their own homes. It will also substantially relieve the financial burden of Social Security from on-coming generations. Investment earnings will supplement the FICA taxes. This can happen whenever surplus generated above reinvestment requirements are used to reduce FICA taxes.

Should the housing market become saturated, investment of OASI reserves could be shifted to high quality State and Municipal bonds. If a number of Federal Programs are transferred to the States, as proposed by President Reagan's administration, there will undoubtedly be a growing need for additional borrowings at the State and local levels. In the future even public utility bond issues might provide for suitable investment of Trust Funds, or mass transportation needs etc.

Finally, this proposal is not intended to be "letter perfect," or a one and only solution to the Social Security fiscal problem. With the application of creative imagination, however, it may provide a base upon which to build a new approach to the problem.

FOOTNOTES

[1] Social Security Bulletin, November 1981/Vol. 44, No. 11, page 30. See Exhibit A.

[2] See Social Security Bulletin, May 1981/Vol. 44, No. 5, page 6, "National Commission on Social Security: Recommendations." See Exhibit B.

[3] President Ronald Reagan stated in his State of the Union message to Congress, January 26, 1982, "A one percent rise in unemployment will increase the Federal deficit by $25 billion." Hence a two percent drop in unemployment would decrease the Federal deficit by $50 billion.

[4] A "portfolio" effect may be explained as follows: If one had a portfolio of high-priced stocks and added a number of low-priced stocks to it, the effect would be to lower to some extent the total value of the portfolio.

[5] See opening statement of Senator William L. Armstrong, Chairman, Senate Social-Security Subcommittee, delivered July 7, 1981 to the U.S. Senate SS. Subcommittee. See Exhibit C.

TABLE 1

OASI Trust Fund Reserve
Investment and Cash Flow Schedule
Funds Invested in 30 year Fixed-Rate Home Mortgages to Yield 9%
One Thirteen Year Cycle of Investments

Year	1 OASI Fund Beginning Balance Billions	2 Investment Outflow From Col. 1[1] Billions	3 Col. 2 Cumulative Billions	4 Fund Bal. After Investment In Col. 2 Billions	5 Fund Gain Due to Increased Employment[2] Billions	6 Amortized Repayment[3] Col. 3 x .0966 Billions	7 Total Gain To Fund Col. 5 + Col. 6 Billions	8 OASI Fund Cum Gain From Col. 7 Billions	9 Fund Ending Balance[4] Billions
1	25.9	11.0	11.0	14.9	4.0	1.1	5.1	5.1	20.0
2	20.0	11.2	22.2	8.8	4.2	2.1	6.3	11.4	15.1
3	15.1	11.9	34.1	3.2	4.4	3.3	7.7	19.1	10.9
4	10.9	12.4	46.5	(1.5)	4.6	4.5	9.1	28.2	7.6
5	7.6	12.8	59.3	(5.2)	4.8	5.7	10.5	38.7	5.3
6	5.3	13.4	72.7	(8.1)	5.0	7.0	12.0	50.7	3.9
7	3.9	13.9	86.6	(10.0)	5.2	8.4	13.6	64.3	3.6
8	3.6	14.5	101.1	(10.9)	5.4	9.8	15.2	79.5	4.3
9	4.3	15.0	116.1	(10.7)	5.6	11.2	16.8	96.3	6.1
10	6.1	15.6	131.7	(9.5)	5.8	12.7	18.5	114.8	9.0
11	9.0	16.3	148.0	(7.3)	6.0	14.3	20.3	135.1	13.0
12	13.0	16.9	164.9	(3.9)	6.2	15.9	22.1	157.2	18.2
13	18.2	17.6	182.5[5]	0.6	6.5	17.6	24.1	181.3[6]	24.7

[1] OASI assets invested in U.S. Government Securities, June 1981, $25.9 billion. Col. 2, takes from these reserves. Year 1 $11 billion, increasing by 4% per year (inflation factor), S.S. Bul., Nov. 1981, Vol. 44, No. 11, pg. 30.

[2] Assume 2% decreased in unemployment, OASI Fund gains $4.0 billion. Increase by 4% per year (inflation factor). See Nat'l Commission on S.S. recommendations, S.S. Bul., May 1981, Vol. 44, No. 5, pg. 6.

[3] Equal monthly payment to amortize a loan of $1,000 @ 9% for 30 years = $8.05 x 12 = $96.60 per year, or .0966 per one dollar

[4] Ending balance, Col. 9 = Col. 1 - Col. 2 + Col. 7

[5] Total Investments = $182.5 billion (Col. 3, Line 13), about $171 billion of the 182.5 billion becomes a capital sum whic can be consistently invested to earn 9%, compounded into the indefinite future.

[6] Total cash inflow to OASI Fund = $181.3 billion, Year 13, Col. 8.

TABLE 2

(Continuation of Table #1)
OASI Trust Fund Reserve
Investment and Cash Flow Schedule
Funds Invested in 30 year Fixed-Rate Home Mortgages to Yield 9%
Second Thirteen Year Cycle of Investments

	1	2	3	4	5	6	7	8	9
Year	OASI Fund Beginning Balance Billions	Investment Outflow From Col. 1[1] Billions	Col. 2 Cumulative Billions	Fund Bal. After Investment In Col. 2 Billions	Fund Gain Due to Increased Employment[2] Billions	Amortized Repayment[3] Col. 3 x .0966 Billions	Total Gain To Fund Col. 5 + Col. 6 Billions	OASI Fund Cum Gain From Col. 7 Billions	Fund Ending Balance[4] Billions
14	24.9	18.3	200.8[7]	6.4	6.8	19.4	26.2	207.5	32.6
15	32.6	19.0	219.8	13.6	7.1	21.2	28.3	235.8	41.9
16	41.9	19.8	239.6	22.1	7.4	23.1	30.5	266.13	52.6
17	52.6	20.6	260.2	32.0	7.7	25.1	32.8	299.1	64.8
18	64.8	21.4	281.6	43.1	8.0	27.2	35.2	334.3	78.6
19	78.6	22.3	303.9	56.3	8.3	29.4	37.7	372.0	94.0
20	94.0	23.2	327.1	70.8	8.6	31.6	40.2	412.2	111.0
21	111.0	24.1	351.2	86.9	8.9	33.9	42.8	455.0	129.7
22	129.7	25.1	376.3	104.6	9.3	36.4	45.7	500.7	150.3
13	150.3	26.1	402.4	124.2	9.7	38.9	48.6	549.3	172.8
24	172.8	27.1	429.5	145.7	10.1	41.5	51.6	600.9	197.3
25	197.3	28.2	457.7	169.1	10.5	44.2	54.7	655.6	223.8
26	223.8	29.3	487.0[5]	194.5	11.0	47.0	58.0	713.6[6]	252.5
Years 14-26 Total		304.5							

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[1] OASI assets invested in U.S. Government Securities, June 1981, $25.9 billion. Col. 2, takes from these reserves. Year 1, $11 billion, increasing by 4% per year (inflation factor), S.S. Bul., Nov. 1981, Vol. 44, No. 11, pg. 30.

[2] The original decrease in unemployment, now employed, are still contributing FICA taxes which increase 4% per year (inflation rate assumed to consistently average 4%). S.B. Bul. No. 1981, Vol. 44, No. 5, pg. 6.

[3] Equal monthly payment to amortize a loan of $1,000 @ 9% for 30 years = $8.05 x 12 = $96.60 per year, or .0966 per one dollar.

[4] Ending balance, Col. 9 = Col. 1 - Col. 2 + Col. 7

[5] Total Investments = $487 billion (Col. 3, Line 26), about $404 billion of this amount becomes a capital sum which can be consistently invested to earn 9%, compounded into the indefinite future. If continuously invested for 30 more years @ 9% compounded, it would produce a $5.4 trillion dollar surplus!

[6] Total cash inflow to OASI Fund = $713.6 billion, Year 26, Col. 8.

[7] Balance, Table 1, Col. 3, Line 13 = $182.5 + $18.3, Col. 2, this Table = $200.8

TABLE 3

If Investment Monies
Are Advanced from General Revenues
Repayment Schedule

Year	1 Gov't. Advances Billions	2 Investment Requirement From Table 1 Billions	3 Cash Inflow Table 1, Col. 7 Billions	4 Needed to Fin. Next Year's Investment Billions	5 Total[1] Col. 3 + Col. 4 Billions	6 Surplus to Repay Gov't Advance Col. 3 - Col. 5 Billions	7 Repay Gov't. Advance[2] Col. 1 Billions
1	11.0	11.0	5.1	6.1	11.2	(6.1)	
2	6.1	11.2	6.3	5.6	11.9	(5.6)	
3	5.6	11.9	7.7	4.7	12.4	(4.7)	
4	4.7	12.4	9.1	3.7	12.8	(3.7)	
5	3.7	12.8	10.5	2.9	13.4	(2.9)	
6	2.9	13.4	12.0	1.9	13.9	(1.9)	
7	1.9	13.9	13.6	0.9	14.5	(0.9)	
8	0.9	14.5	15.2		15.0	0.2	
9		15.0	16.8		15.6	1.2	
10		15.6	18.5		16.3	2.2	
11		16.3	20.3		16.9	3.4	
12		16.9	22.1		17.6	4.5	11.0
13		17.6	24.1		18.3	5.8	6.1
14		18.3	26.2		19.0	7.2	5.6
15		19.0	28.3		19.8	8.5	8.4
16		19.8	30.5		20.6	9.9	7.7
Total	36.8					Total	36.8

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[1] Amount in Col. 5 is the amount needed for investment in Col. 2, the following year. Deficit is provided by additional borrowing from the general revenues, as shown in Col. 1.

[2] The accumulated surplus years 9-12 will repay advances from the general revenues represented in Col. 1, and shown as deficits in years 1-7 in Col. 6.

Exhibit A

Table M-5.—Old-age and survivors insurance trust fund: Status, 1940–81

[In thousands]

Period	Receipts			Expenditures				Assets at end of period		
	Net contribution income[1]	Reimbursements from general revenues[2]	Net interest[3]	Cash benefit payments[4]	Rehabilitation services for disabled	Transfers to railroad retirement account[5]	Net administrative expenses[6]	Invested in U.S. Government securities[7]	Cash balances[8]	Total assets
Fiscal year:										
1940	$550,000	....	$42,489	$15,805	....	....	$12,288	$1,738,100	$6,598	[9] $1,744,698
1945	1,309,919	....	123,854	239,834	....	....	26,950	6,546,281	67,100	6,613,381
1950	2,106,388	$3,604	256,778	727,266	....	....	56,841	12,644,823	247,789	12,892,612
1955	5,087,154	....	438,029	4,333,147	....	−39,551	103,202	20,580,491	560,511	21,141,001
1960	9,842,685	....	517,130	10,269,709	....	600,437	202,369	19,748,848	1,079,877	20,828,725
1961	11,292,676	....	531,103	11,184,531	....	331,734	235,889	19,523,517	1,376,833	20,900,350
1962	11,454,643	....	541,254	12,657,835	....	360,788	251,490	18,434,665	1,191,468	19,626,133
1963	13,327,762	....	514,822	13,844,584	....	422,523	262,527	17,613,190	1,325,894	18,939,083
1964	15,502,726	....	541,552	14,579,166	....	402,636	302,709	18,304,869	1,393,982	19,698,851
1965	15,857,212	....	586,237	15,225,894	....	435,638	300,283	18,765,724	1,414,761	20,180,485
1966	17,865,947	....	594,758	18,071,453	....	443,820	253,680	17,908,655	1,963,580	19,872,236
1967	22,567,002	78,000	725,901	18,885,714	588	508,046	333,901	21,764,099	1,751,290	23,515,389
1968	22,662,430	78,000	899,397	20,737,093	277	437,634	447,309	23,234,480	2,298,423	25,532,904
1969	25,952,737	381,545	1,014,080	23,732,010	1,806	491,482	465,028	26,220,292	1,970,647	28,190,939
1970	29,954,673	442,151	1,349,613	26,266,928	1,239	578,818	474,035	30,106,913	2,509,443	32,616,355
1971	31,915,231	448,916	1,618,138	31,101,018	1,859	613,026	551,889	31,361,082	2,969,766	34,330,848
1972	35,710,725	487,546	1,718,572	34,540,813	1,555	724,341	581,923	33,188,486	3,210,572	36,399,058
1973	41,318,177	474,645	1,846,518	42,169,744	2,470	782,954	667,335	35,487,612	928,284	36,415,896
1974	48,454,693	441,788	2,039,243	47,848,838	3,873	908,383	723,315	37,703,419	163,589	37,867,008
1975	56,017,343	447,323	2,292,182	54,838,818	7,731	981,785	847,708	39,879,154	68,659	39,947,814
1976	59,554,690	425,317	2,347,000	62,140,449	7,480	1,212,303	934,713	37,955,347	24,529	37,979,876
1977	68,894,809	613,902	2,286,888	71,270,519	7,502	1,207,841	992,727	35,397,620	−25,407	35,372,213
1978	74,046,779	612,927	2,151,741	78,524,092	6,461	1,588,664	1,086,180	30,955,085	23,179	30,978,264
1979	84,357,910	615,229	1,920,140	87,591,968	16,980	1,447,532	1,072,218	27,317,094	425,752	27,742,846
1980	97,607,645	557,253	1,886,219	100,615,304	11,090	1,441,988	1,159,824	23,565,572	1,000,185	24,565,757
July–Sept. (transition quarter)[10]	16,105,848	....	80,432	16,875,545	1,714	....	233,695	37,042,171	13,031	37,055,202
1980										
June	6,012,089	23	642,804	8,152,852	....	1,441,988	83,586	27,505,441	9,491	27,514,932
July	5,876,310	−2	18,490	9,262,423	32,880	....	103,675	23,948,635	62,117	24,010,752
August	12,023,835	27	99,989	9,355,717	−29,592	....	91,168	25,941,215	776,095	26,717,310
September	7,273,640	−12	62,643	9,365,488	....	....	122,337	23,565,572	1,000,185	24,565,757
October[11]	10,230,064	7	74,857	9,437,107	....	....	101,834	24,242,956	1,088,789	25,331,745
November	7,946,851	....	84,924	9,431,782	....	....	108,348	22,809,503	1,013,888	23,823,391
December	7,538,326	539,936	544,994	9,520,900	....	....	102,248	21,811,516	1,011,984	22,823,500
1981										
January	9,469,856	40	18,059	9,622,902	4,110	....	116,956	21,750,238	817,250	22,567,487
February	10,350,153	....	103,204	9,724,749	....	....	80,453	22,912,441	303,200	23,215,641
March	10,519,603	6	65,927	9,907,321	....	....	131,940	23,542,617	219,300	23,761,918
April[11]	13,088,424	−16	202,244	9,737,758	3,432	....	109,279	26,301,281	900,720	27,202,001
May	10,871,842	27	61,593	9,753,891	....	....	109,116	27,026,252	1,246,205	28,272,457
June	9,725,069	1	658,629	9,827,480	....	1,584,932	96,70	25,944,302	1,202,739	27,147,041

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[1] Equals amounts appropriated (estimated tax collections, subsequently adjusted). Includes deposits by States under voluntary coverage agreements and deductions for refund of estimated employee-tax overpayment. Early years reflect former appropriation bases.

[2] From 1947 to 1951, for benefits with respect to certain World War II veterans. Beginning 1966, for military wage credits, and beginning Dec. 1968 for military credits and Federal payment for special age-72 benefits, see footnote 4.

[3] Includes interfund transfer of interest on reimbursed administrative expenses, 1958 to date (see footnote 6).

[4] Before deductions for (1) SMI premium payments and, when applicable, (2) recoupment of overpayments of hospital and medical service benefits provided to OASI beneficiaries. Includes special benefits for persons aged 72 and over not insured under the regular or transitional provisions of the Social Security Act.

[5] The purpose of the financial interchange provisions of the Railroad Retirement Act, as amended, is to place the trust funds in the same position in which they would have been had railroad employment always been covered under OASDHI. Negative figures represent transfers to OASI trust fund. Excludes transfers to HI trust fund for hospital insurance coverage of railroad workers (accounted for in table M-7).

[6] Beginning 1951, adjusted for reimbursements to trust fund of small amounts for gifts, sales, or services. Beginning 1953, includes expenses for central and regional office building construction. Except for reimbursements from the appropriate trust fund to Treasury Department for its expenses as incurred, beginning 1957 administrative expenses for OASI and DI were paid initially from OASI trust fund with subsequent reimbursement, plus interest (see footnote 3), from DI trust fund for allocated cost of DI operations. Beginning 1966, subject to subsequent adjustment among all four social security trust funds for allocated cost of each operation.

[7] Book value: includes net unamortized premium and discount, accrued interest purchased, and repayment of interest accrued on bonds at time of purchase.

[8] Minus figures, if any, represent overdrafts that are covered by redemption of securities on first working day of following month.

[9] Reflects assets of predecessor fund, the old age reserve account, January 1937 December 1939.

[10] Between end of fiscal year 1976 (June 30) and start of fiscal year 1977 (Oct. 1976).

[11] Public Law 96-403 approved October 9, 1980, provides for the reallocation of social security tax receipts between the OASI and DI trust funds for calendar years 1980–81. Transfers from the DI to the OASI fund were required to implement the change retroactive to January 1980. A $3-billion transfer in October 1980 represented the accumulated tax receipts, and a $121-million transfer in April 1981 was the interest earned on this amount.

Source: Unpublished Treasury monthly reports keyed to Final Statement of Receipts and Expenditures of the U.S. Government.

Exhibit B

The Major Recommendations

The Commission is making recommendations designed to help the social security system adapt to changing economic and social conditions.

Major changes in financing and a gradual approach toward a later retirement age will be necessary if the public's confidence in social security's ability to redeem its pledges is to be restored. The increased lifespan and better health of the American people justify raising the age of eligibility for full retirement benefits from age 65 to 68; beginning in the year 2001.

As the taxes necessary to support the program increase, a limit should be placed on social security's exclusive reliance on payroll tax financing. One-half of the cost of hospital insurance should be funded from general revenues. In addition, the social security trust funds should be partially funded from general revenues if and when payroll tax rates for social security and hospital insurance combined exceed 18 percent (9 percent on employers and 9 percent on employees).

Full wage indexing of yearly earnings should continue in computing the initial benefit level, to assure that initial benefits will reflect not only changes in the cost of living, but also increases in productivity that have occurred during a person's worklife.[13] When increases in the wages of covered workers in the economy fall behind increases in consumer prices, the automatic 100-percent indexing of postretirement benefits to the Consumer Price Index should be reduced temporarily. The full amount of the reduction should be restored as soon as this wage/price difference reverses.

Several improvements should be made in disability insurance, Medicare, Medicaid, and supplemental security income benefits. The Commission believes that all of these programs would be better managed by a Social Security Board, as originally conceived, as an independent agency of government, with trust-fund accounts that are kept separate from the Federal budget. In this way benefits on which so many citizens depend for their day-to-day existence will not be subject to arbitrary cuts for budget-balancing purposes, and the difficult problems of financing the program can be worked out with fewer political constraints.

The Commission is making a total of 88 recommendations. The recommendations it is making for social security will restore the program's financial soundness, cement the public confidence on which it rests, and result in improvements in the program. In addition, the Commission is making recommendations for changes in the Medicaid and supplemental security income programs. While these changes are also needed now, the question of what priority they deserve relative to other necessary programs of government must be decided by the President and the Congress.

The Limits of Predictability

Planning for social security would be much easier if the future were clearer. The Commission tried to determine the future costs of both the present program and the program improvements it wished to recommend in order to estimate what levels of taxation will be needed. No such predictions can be assayed without first making certain assumptions about birth rates, mortality rates, and future trends in the economy—in general, the same type of assumptions the private insurance industry must make. In doing so, the members of the Commission recognized the inherent limitations of both actuarial assumptions and economic forecasting.

A central question involved in the long-run financing of social security is whether the ratio of active workers to beneficiaries will decline, as is now predicted, requiring substantially higher taxes even to maintain benefits at present levels. No one can predict with confidence whether the birth rate, which dropped for almost 20 years after the widespread availability of reliable contraception until leveling off recently, will stabilize, decline further, or resume an upward course. Even the medical profession cannot be certain of the future trend in life expectancy, even though it has been rising throughout this century. Nor can anyone foresee the course of technology and public policy well enough to tell what the long-term average rate of unemployment will be.

Short-term financing of social security is especially sensitive to changes in the economy. Under current "intermediate" assumptions,[14] each 1-percent increase in unemployment reduces income to the social security and hospital insurance trust funds by about $2 billion per year. Each 1-percent increase in the Consumer Price Index produces an automatic social security benefit increase of $1.4 billion per year. Yet the most sophisticated econometric models have failed to forecast these conditions with precision. Most do not attempt to project more than 5 to 10 years into the future. It is important to recognize that all estimates for the future are based on assumptions about economic and demographic trends that need to be reviewed and updated as conditions change.

Equality of Sacrifice

The Commission considered the argument that the financial stability of the program, both present and

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[13] For a description of how past wages are indexed to calculate a beneficiary's initial benefit, see chapter 7, page 56 (in the full report).

[14] Social security cost estimates are calculated three ways, according to three separate sets of economic and demographic assumptions: Optimistic, pessimistic, and intermediate. Policymakers usually select the intermediate set of assumptions for costing purposes.

Exhibit C

Opening Statement of
Senator William L. Armstrong, Chairman
Senate Social Security Subcommittee
July 7, 1981

We are here today to consider the future of the nation's largest domestic program...Social Security.

Social Security is so woven into the nation's economic and social fabric that it is hard to grasp its daily impact on 150 million Americans. A typical American will work 45 years and, with each paycheck, he and his employer will contribute to Social Security throughout his working life. In retirement, the average worker and his spouse will get a Social Security check of $568 -- adjusted annually for inflation -- each month for an average of 15 years. For this couple, and millions of others, this check is a critical, if not the only, source of retirement income.

This monthly check, however, does not come from the taxes he paid while working. The check is paid by those who are now working, and paying up to $3,500 annually in Social Security taxes. In turn, these workers trust the next generation will finance their retirement on a pay-as-you-go basis.

The commitment made to this worker and 150 million others is now on the line.

Social Security is going broke.

Unless decisive action is taken, the trust funds will soon be unable to make ends meet; the Social Security System will be destroyed. Social Security has been operating in the red for six straight years, and now loses $10,000 every minute. Today, the System has enough money to pay full benefits for only two months. By approximately November 1, 1982, the Social Security Pension Reserve will be exhausted and the fund will not be able to pay even a month of full pension benefits, according to the 1981 Social Security Trustees Report. Long-term, the problem is even worse: Social Security faces a one and a half trillion dollar shortfall over the next 75 years, according to the Trustees.

I doubt anyone can comprehend the disastrous consequences of a bankrupt Social Security.

Social Security is the financial lifeblood for most of its 36 million recipients. The System is going broke. It must be repaired.

Inescapable facts frame this hearing and are the backdrop for the work of this subcommittee.

I have with me six charts portraying the Social Security crisis. The first chart paints -- in red -- the System's mounting deficit. Social Security has operated in the red for six straight years, and by 1982, will not be able to pay full benefits. For all practical purposes, the System will be insolvent.

How did we get in this mess? These other charts tell the story. The second chart shows the explosion in benefit payments since 1950. In 30 years, benefits have been adjusted upward 699 percent. One trillion dollars has been paid out. Averge monthly benefits per person in 1935 were $22. Today, the average exceeds $370. We are now to the point where in 1985 alone total pension and disability benefit payments will exceed $220 billion. We are paying benefits in one year that equal one-fifth of the total benefits paid out over the last 30 years.

Frankly, Congress has been promising benefits it just can't deliver.

These benefits are financed on a pay-as-you-go basis. In other words, benefits paid today are being financed through today's Social Security payroll taxes. The third chart shows the radical changes that have reshaped the

American workplace, and jeopardize Social Security's long-term survival. In 1950, there were some 16 workers paying for each person receiving Social Security benefits. In 1980, only three workers paid taxes for each beneficiary and in slightly more than one generation, there will be only two workers supporting each person drawing benefits.

Obviously, fewer people are carrying the burden. The result is dramatic, though not surprising. Social Security taxes have skyrocketed. This is shown in the fourth chart.

In 1940, the maximum combined employer-employee Social Security tax was a mere $60 annually. Today, that tax exceeds $3,000 and will rise to $9,000 by 1990. Incredibly, even with these higher taxes, Social Security will have an accumulated deficit of $111 billion by 1985.

Possibly even more dramatic is the chart's inset. Since 1950, real wages in the United States increased 490 percent, while federal taxes increased 594 percent. And Social Security taxes? They soared 2,011 percent.

Can anyone seriously contend that Social Security payroll taxes can or should be pushed even higher?

Some believe the cure for Social Security's problem is using general revenues. Social Security trust funds have always been kept apart from the Federal Treasury. Earlier I said Social Security is losing $10,000 every minute. Well, the Federal Treasury is losing $173,000 a minute! Our national debt has increased 27 times faster than our population. Can anyone seriously contend that a federal government with a trillion dollar debt can bail out Social Security? That would be like asking Amtrak to bail out Conrail. How much more can Congress increase deficit spending which is the prime cause of ruinous inflation?

So there it is. Social Security is very deeply in debt. The System now lacks the financial wherewithal to pay promised benefits. Incredibly, all this occurs at a time when benefit payments are soaring.

But there is reason to hope. Social Security can be lifted out of this financial quicksand. But permanent solvency -- which is our goal -- can only be achieved by facing the following facts.

First. Social Security must not become a political grenade lobbed back and forth for exploitive purpose. Those seeking political gain at the expense of Social Security solvency perform a national disservice. I am absolutely committed to fashioning a fair, non-partisan, compromise bill that will place Social Security on a sound financial bedrock and that will ensure a piece of that rock for our retirees.

Second. Congress must learn from its past mistakes in shaping Social Security policy, and then resolve not to repeat them. Congress has overpromised benefits without providing the long-term financing necessary to pay for them.

Third. Congress can no longer mislead the American people. Just four years ago, Congress enacted a sweeping Social Security reform bill that resulted in history's largest peacetime tax increase. It was hailed by President Carter "as the guarantee that from 1980 to 2030, Social Security funds will be sound." Experience has proven the prediction wrong and this final chart shows the danger of over-optimistic estimates. In 1978 -- the same year Congress passed its Social Security "reform bill" -- the Trustees for Social Security said the System would remain solvent forever. Yesterday's announcement by the Trustees flatly contradicts the earlier report.

This may be our last, best chance to achieve permanent solvency and assure the retirement security for the people who pay for the System and rely on it.

If we fail, Congress will lose forever any vestige of credibility on this issue.

Fourth. Congress must acknowledge that Social Security has the potential for fracturing American Society by creating a new kind of "generation gap." Those now receiving Social Security believe their juniors are obligated to pay the taxes necessary to support their benefits. Yet younger Americans grow increasingly bitter about their heavy Social Security tax burden. This conflict must be squarely faced.

This subcommittee should operate from the premise that all Americans deserve a financially sound, compassionate Social Security System, and one that offers reasonable value for the Social Security taxes they pay over the years.

Unfortunately, pessimism about this is high. A recent ABC-Washington Post poll reported that 75 percent of the public believe they will never collect a penny of benefits in their lifetimes.

Today we will learn more about the dimension of the Social Security financing crisis from Secretary Schweiker and Social Security Commissioner Svahn. Yesterday, July 6, 1981 the Administration released its 1981 Social Security Trustees Report. The findings show the Social Security funds are being depleted at an alarming rate, and the situation is much worse than was reported just a year ago.

It is critical that this Congress and all Americans understand the exact nature and depth of the Social Security problem. We Americans have demonstrated time and again that when we understand our problems we have an amazing capacity to work together to solve them.

Let us undertake these hearings in that spirit. This is the time for all of us to join together to save the Social Security System.

I welcome Secretary Schweiker and Commissioner Svahn.

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